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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

vs.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal
of the State of California
for the First Appellate District

JOINT APPENDIX

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Superior Court of the State of California
for the City and County of San Francisco

No. 673492

Container Corporation of America,
Plaintiff,

vs.

Franchise Tax Board,
Defendant.

[Filed Feb. 23, 1978]

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Superior Court of the State of California
for the City and County of San Francisco
[Title Omitted in Printing]

I.

STIPULATION OF FACTS

1. IT IS HEREBY STIPULATED AND AGREED by and between the parties hereto, through their respective attorneys of record, for purposes of this case only, that the following facts shall be taken as true and shall be adopted as part of the Court's findings of fact. This stipulation shall not be construed as a concession by either party of the relevancy or materiality of any of the facts stipulated herein, and the parties hereto expressly reserve the right to argue the relevancy or materiality of any of the facts herein stipulated to be true.

2. Except as otherwise provided herein, all exhibits attached hereto, or otherwise incorporated herein by reference, are included for the limited purpose of showing the contents thereof and not for the truth of the matters therein set forth. Provided, however, that either party may offer any of such documents for additional purposes subject to objections as to competency, relevancy and materiality but not subject to the best evidence objection or any objection as to their genuineness or the due execution thereof.

3. Nothing herein contained shall be construed as a waiver by any of the parties hereto of their rights to review on appeal any question of law or fact arising in this action in the same manner and to the same extent

as if the facts herein set forth had been proved in open court.

4. Each party may introduce at the trial of this cause any other or further evidence which is not inconsistent with the facts stated herein. To the extent possible, notice of each intended introduction shall be given to the other party sufficiently in advance of trial to enable the other party to meet such evidence.

5. The parties will make any computations necessary for inclusion in appropriate findings after the court's decision in this matter. In the event the parties are unable to agree on the computation, the case may be reopened by either party to submit any additional evidence which may be required in making such computation.

6. Except as otherwise noted, the facts set forth herein pertain only to the calendar years 1963-1965.

7. This stipulation shall be valid only in the above-entitled action.

II.

BACKGROUND OF ACTION

A.

8. This action involves a suit for refund of franchise taxes paid under the Bank and Corporation Tax Law for the income years (i.e., calendar years) 1963, 1964 and 1965 (taxable years 1964, 1965 and 1966).

B.

9. At all times mentioned herein, Container Corporation of America (hereinafter "CCA") was and is a cor-

poration organized and existing under and by virtue of the laws of the State of Delaware. At all times mentioned herein CCA had its principal executive offices in the State of Illinois.

C.

10. The following facts have been admitted in the pleadings: During the income years 1963, 1964 and 1965 CCA owned a controlling interest in subsidiaries located in Western Europe and Latin America; with respect to all but the Colombian subsidiaries, stock not owned by CCA or its agents is owned by nationals of the particular foreign country. (Since 33% of the stock of Carton de Colombia is traded on a Colombian exchange, it cannot be determined with certainty that all owners were, or are, Colombians.) Throughout this stipulation these subsidiaries will be referred to collectively as the "foreign subsidiaries." Greater detail regarding the foreign subsidiaries is provided in sections VI and VII below.

D.

11. Concurrent with the filing of its Bank and Corporation Franchise Tax returns for income years 1963, 1964 and 1965, CCA paid or had previously paid franchise taxes to the Franchise Tax Board on the dates and in the amounts reflected below:

1. Income Year 1963

Date	Type of Payment	Amount
March 15, 1964	estimated	$142,000.00
September 15, 1964	with return	$ 21,172.01

2. Income Year 1964

Date	Type of Payment	Amount
March 15, 1965	estimated	$153,000.00
September 14, 1965	with return	$ 15,422.14

3. Income Year 1965

Date	Type of Payment	Amount
June 15, 1965	estimated	$ 43,415.00
September 15, 1965	estimated	$ 5,848.70
March 15, 1966	estimated	$110,736.30
September 15, 1966	with return	$ 14,590.29

E.

12. On January 23, 1969 the Franchise Tax Board issued to CCA three Notices of Additional Tax Proposed to be Assessed for the income years and in the amounts reflected below:

No.	Income Year	Taxes Assessed
J138788	1963	$15,304.87
J138789	1964	$33,888.82
J138790	1965	$22,750.41

Copies of these notices are attached to the complaint as Exhibit A to Exhibit 2, Exhibit A to Exhibit 5 and Exhibit A to Exhibit 7 for taxable years 1964, 1965 and 1966, respectively.

F.

13. On March 17, 1969, CCA filed with the Franchise Tax Board a protest of the three proposed assessments described in paragraph E above. A copy of this protest is attached to the complaint as Exhibit A of Exhibit 2.

G.

14. On April 28, 1969, CCA paid to the Franchise Tax Board $37,970.15 which amount was the result of certain federal adjustments made for income years 1963, 1964 and 1965. The amount attributable to tax and interest for each income year is reflected below:

Income Year	Tax	Interest
1963	$10,092.40	$3,095.00
1964	$11,609.90	$2,863.77
1965	$ 8,687.43	$1,621.65

This payment was made under cover of a letter from CCA to the Franchise Tax Board a copy of which is attached to the complaint as Exhibit E to Exhibit 2. Receipt of said letter was acknowledged by the Franchise Tax Board.

H.

15. On June 20, 1973, CCA paid additional franchise taxes, including interest, to the Franchise Tax Board for income years 1963, 1964 and 1965. The amount attributable to tax and interest for each income year is reflected below:

Income Year	Tax	Interest
1963	$15,304.87	$ 8,494.20
1964	$33,888.82	$16,774.97
1965	$22,750.41	$ 9,896.43

This payment was made under cover of a letter from CCA to the Franchise Tax Board a copy of which is attached to the complaint as Exhibit D to Exhibit 2. Receipt of said letter was acknowledged by the Franchise Tax Board.

I.

16. On August 2, 1973, the Franchise Tax Board affirmed without adjustment the three proposed assessments described in paragraph E above. CCA was advised of this action by three Notices of Action on Taxpayer's Protest mailed to it by the Franchise Tax Board on the same date. Copies of the Notices of Action on Taxpayer's Protest are attached to the complaint as Exhibit C to Exhibit 2, Exhibit C to Exhibit 5 and Exhibit C to Exhibit 7 for income years 1963, 1964 and 1965, respectively.

J.

17. On October 26, 1973 CCA filed with the Franchise Tax Board three claims for refund for income years 1963, 1964 and 1965 in the amounts reflected below:

Income Year	Amount
1963	$31,118.00
1964	$49,059.20
1965	$46,828.93

Copies of these claims for refund are attached to the complaint as Exhibits 2, 5 and 7 for income years 1963, 1964 and 1965, respectively.

K.

18. On October 29, 1973, the Franchise Tax Board issued to CCA Notices of Assessment for the income years and in the amounts reflected below:

Income Year	Amount
1963	$11.95
1964	$32.02
1965	$21.49

Copies of these Notices of Assessment are attached to the complaint as Exhibit 3. On November 2, 1973, CCA paid in full these assessments.

L.

19. On January 11, 1974, the Franchise Tax Board issued to CCA Notices of Action denying the three claims for refund of CCA described in paragraph J above except for the partial refunds reflected below:

Income Years	Refund
1963	$3,443.26
1964	$3,913.67
1965	$2,842.06

20. With regard to the balance claimed, CCA's claims for refund were denied by the Franchise Tax Board. Copies of these Notices of Action are attached to the complaint as Exhibits 4, 6 and 8.

M.

21. It is stipulated that the figures in Exhibits A and B to this stipulation are accurate. The net income figures for CCA and the foreign subsidiaries in Exhibit A are derived from the financial statements of CCA and the latter were included in Form 2952 which is attached to CCA's United States income tax return. The 2952s were the starting point for the California auditor in determining CCA's California tax liability. The income figures on p. 7 of Exhibit A are tax income (as opposed to financial income) figures. The 2952 information was prepared in accordance with the generally accepted accounting principles of the foreign country. In completing Form 2952,

"monetary items" (current assets and liabilities and long-term debt) were taken into account at the current exchange rate between the local currency and the U.S. dollar and "non-monetary accounts" (essentially plant and equipment, depreciation reserves, investments, capital stock, surplus and general inventory) were taken into account at the historical rate, i.e., the exchange rate in effect in the year when the items were entered on the subsidiaries' books. In computing this information, CCA's subsidiaries lump together all forms of revenue from sources other than the sale of products, subtract from that amount certain miscellaneous expenses and report a single net income figure for those sources of revenue.

N.

22. For the years in question the corporate franchise tax returns filed by CCA with the Franchise Tax Board did not include the foreign subsidiaries as part of a unitary business with CCA. In its administrative determinations made in this case, and in its answer filed herein, the Franchise Tax Board took the position that CCA and the foreign subsidiaries constituted one unitary business for purposes of the corporation franchise tax. In the franchise tax returns filed by CCA and in the protests, claims for refund and complaint filed by CCA, the position was taken that CCA was not involved in a unitary business with the foreign subsidiaries.

III.

BACKGROUND OF CCA

A.

23. CCA was incorporated under the laws of Delaware on June 18, 1926, as Container Corporation of America. CCA was the successor to an existing business known as the Chicago Mill and Lumber Company, founded in 1881 in Chicago by Hermann Paepcke. The primary activity of this company was the manufacture of wooden containers. By 1910 it was one of the largest lumber and box organizations in the United States. The company's interest in the possibilities of paperboard as an adjunct to wood in container production led to the purchase of the company's first paperboard mill in 1915. Upon the death of Hermann Paepcke in 1922, his son, Walter, took over control of the business. By this time the company had a second paperboard mill and two corrugated plants. At the time of incorporation there were approximately fourteen factories as well as various mills. The capital stock of CCA was first traded on the New York Stock Exchange on December 28, 1935. In 1938 CCA built a large new pulp mill in Florida which gave CCA the capacity to supply the raw materials for a large measure of its own production.

B.

24. In 1938 CCA's profits dipped to $29,470 from $1,784,000 in the preceding year. As a result CCA instituted an across-the-board system of regional decentralization. Each regional vice president was responsible for all phases of the operations (manufacturing, sales and general administration) of all properties. Plants and mills were

similarly organized with each general manager reporting on all phases of the operations to the appropriate regional vice president. It is the view of many people in the company that this decentralization reorganization was chiefly responsible for the successes of CCA in the 1940s and later years. This organizational pattern continues today. Decentralization is the result not only of the philosophy of CCA but also of the fact that the product produced is entirely custom made.

IV.

BACKGROUND OF FOREIGN SUBSIDIARIES

A.

25. During the years in question, CCA controlled twenty foreign subsidiaries which are listed below by name and year established or date of acquisition and grouped by country. All of the subsidiaries except Carton International, S.A. were engaged in some aspect of the paperboard/packaging business. CCA controlled no other foreign subsidiaries.

	Date Established	Date Acquired	Percentage of Ownership by CCA or a Subsidiary of CCA
Colombia			
Cellulosa y Papel de Colombia, S.A.	1961		66.7(C)
Carton de Colombia, S.A.	1944		66.8
Venezuela			
Corrugadora de Carton, S.A.	1953		80
Carton de Venezuela, S.A.		1954	80
Union Grafica, S.A.		1954	80
Cartones Nacionales, S.A.	1959		82
Fibras Industriales de Venezuela, S.A.	1960		80
Cartoenvases Valencia, S.A.(B)	1965		80

foreign subsidiaries. CCA did not expect to, nor did it subsequently, acquire raw materials or finished products from these subsidiaries. CCA did not expect to, nor did it except to the limited extent described below, sell raw materials or finished products to these subsidiaries, or to third parties in those foreign countries.

C.

27. In those instances where CCA or the subsidiaries or agents did not own 100% of a foreign subsidiary, participation by foreign nationals was felt to be desirable because it was hoped this would lead to more favorable consideration by the local government, minimize the sometimes adverse or antagonistic reaction experienced by United States-owned subsidiaries in foreign countries, assure the acceptance by the local business community, make local management more readily available to the new business and help make the particular subsidiary more responsive to local needs.

D.

28. The procedure CCA follows in examining the possibilities of acquisition or formation of foreign subsidiaries is dependent on the circumstances. If a subsidiary recommends increased involvement in a present market, or if a nonaffiliated company in that market approaches a member of the group with an offer to sell, or if a subsidiary suggests development of a neighboring market, the staff of the subsidiary will probably perform most of the necessary studies (since they already have an understanding of the relevant business, economic, social and political

factors). Where a recommendation is made to examine a market with which a CCA affiliate is not familiar, CCA's Control Staff will compile the study. When the information is compiled, it will be reviewed by CCA's Senior Vice President for Overseas Operations and possibly a member of the Control and Law Staffs (if an existing subsidiary is to be involved, its management will also review the study). Where an acquisition (or formation) appears desirable, the next step will again depend on the circumstances of the specific proposal. If an existing subsidiary is involved, its Management Committee and Board will review the proposal. Where preliminary approval is given, CCA's Management Committee and Board must pass on it. If approval is given at both of these levels, the Board of the subsidiary will act on the matter. If it approves, the transaction will occur, but if either the Management Committee or the Board of Directors of the subsidiary rejects the proposal, CCA must decide whether it wishes to proceed independently. In a situation where a subsidiary is not involved, CCA's Management Committee and Board will be the only bodies to make the determination.

V.

OPERATIONS OF CCA

A.

29. CCA is an integrated producer of paperboard packaging of various types, producing the paperboard from raw timber and wastepaper in recycling mills, and manufacturing paperboard packaging products from the paperboard. CCA's principal business is the manufacture and sale of corrugated and solid fiber shipping containers, fold-

ing cartons, fiber cans, other paperboard products, paperboard in the form of container board and boxboard, and plastic products consisting principally of packaging components. Based upon statistical reports of domestic industry trade associations, CCA's domestic shipments in 1963-65 of shipping containers and folding cartons represented 5-10% of the totals for those industries and its domestic production of paperboard in 1963-65 represented approximately 6% of the total production of paperboard by the industry. Domestic shipments included all sales and transfers from a domestic plant including sales to other CCA plants or to a CCA subsidiary.

B.

30. During the years in question approximately 46% of CCA's trade sales were accounted for by sales of corrugated and solid fiber shipping containers; approximately 35% by sales of folding cartons, fiber cans and plastic packaging, and approximately 19% by other products, primarily paperboard and paperstock not used in CCA's fabricating operations. Trade sales do not include sales to CCA plants or subsidiaries.

C.

31. CCA had in excess of 10,000 customers in the United States. During the years in question the aggregate sales to CCA's ten largest customers were approximately 15% of its domestic sales.

D.

32. Customers were generally solicited by the plant salesmen in particular assigned geographical areas. Some

customers called CCA directly and requested that CCA design a particular carton or container. Each CCA plant had its own sales force to cover a given geographical area to sell its specific type of manufactured product. CCA also had three regional sales offices to handle national accounts. Regional sales offices service domestic accounts. Foreign accounts with unrelated companies are generally promoted and serviced in one of two ways: A plant's existing domestic account establishes an operation in another country and requests that CCA supply it; or a plant salesman is based in or travels to another country to open an account with a new customer. (CCA's trade sales outside of the U.S. are generally to Canada or Puerto Rico).

E.

33. The basic business of CCA in the United States was the manufacture of container products to the order and specifications of customers. Businesses which utilize packaging in the sale of their products realize that the attractiveness of the package is very important in the sale of their product. Thus the business of CCA was not only manufacturing cartons tailored to the customer's packaging needs but also designing and producing a package for the most effective display of the customer's product.

F.

34. The operations of CCA can be divided into two broad categories, the manufacture of paperboard and the production of packaging material from paperboard.

1. *Paperboard*

(a) General

35. Paperboard is one of two principal products of the paper industry, the other being paper itself. The differences between paper and paperboard are in weight, thickness and rigidity. Paperboard is at least 0.012 inches thick and is heavier and more rigid than paper. Paperboard accounts for nearly half of the total tonnage of all paper and paperboard produced. About 85% of all paperboard produced is used for making shipping containers, folding cartons, set up boxes, and other packaging products. The remainder goes to a variety of such end products as plasterboard, wallboard, playing cards, tags and cardboard.

(b) Raw Materials and Production

36. The principal raw materials used by CCA in the manufacture of paperboard were pulpwood and waste paper. Pulpwood was converted into kraft containerboard in CCA mills in Alabama and Florida. ("Kraft" refers to a type of paperboard made of virtually pure, long virgin fibers.) In approximately 10 other CCA paperboard mills, combinations of pulpwood and waste paper were used to produce the various grades of paperboard described below. Paperboard was then converted at the approximately 40 fabricating plants into shipping containers, folding cartons, fibre cans, and other paperboard products described below. Some paperboard produced in CCA mills was sold to third parties, but approximately 90% was used for CCA's packaging operations. Approximately 85% of CCA's pulpwood requirements were obtained from outside sources. The remainder was from timberlands which

CCA owned or held under long term leases. CCA purchased its requirements of waste paper. It also purchased a relatively small portion of its requirements of paperboard, primarily on a long term basis. Other materials, including pulpwood, were purchased in the open market.

(c) Containerboard

37. Containerboard was the largest grade of paperboard produced. It accounted for approximately 63% of total board production. It is a versatile and relatively inexpensive packaging material consisting of a fluted sheet (corrugating medium) glued between two liners. The linerboard which makes up the liners accounted for 71% of containerboard production, the corrugating medium for 28% and filler and other chip board for the balance.

(d) Boxboard

38. Boxboard is the second largest grade of paperboard produced.

(1)

39. Folding or bending boxboard is used almost exclusively in the manufacture of folding cartons. It is strong enough to permit scoring (making a crease for folding) and folding and has good surface properties for printing.

(2)

40. Foodboard, another type of boxboard, is used exclusively to manufacture such containers as milk cartons and dairy containers and such related disposable products as cups and dishes. Almost all foodboard is made from bleached or semi-bleached pulp. Most foodboard is sized

for water resistance and coated for barrier properties or improved printing surfaces.

(3)

41. Set up or nonbending boxboard is the paperboard used in manufacturing rigid paperboard boxes. Its primary properties are exceptional stiffness, rigidity and resistance to abuse.

(e)

42. CCA also produced a special paperboard which was used in the production of a variety of products including fiber cans, drums, tubes and cores, and office and business supplies such as index cards, postcards and file folders.

2. *Production of Packaging Material*

(a) General

43. CCA's products are used extensively in the packaging and shipping of food products, canned goods, clothing, soaps, beverages, furniture, automotive products and accessories, petroleum products, chemicals, electrical equipment, household equipment, textiles, drugs, tobacco and many other products. The primary types of containers used in packaging are briefly described below.

(b) Corrugated Containers

(1)

44. Corrugated containers are exceedingly versatile packages. This container carries such diverse cargoes as nuts and bolts, bathtubs, household appliances, bulk loads weighing a ton or more, frozen berries, fresh iced poultry, artificial flowers, frozen eggs, etc.

(2)

45. There are more than 1,300 plants producing corrugated boxes in the United States operated by over 700 companies.

(3)

46. Corrugated paperboard consists of a fluted or wavy sheet glued to one or more liners. The most common construction is a sheet of corrugating medium sandwiched between two liners (double-faced board); however, a wide variety of combinations is possible depending on the packaging requirements. If a high degree of flexibility in cushioning is needed, only a single facing or liner is used. Where great strength and rigidity are required for heavy loads, three sheets of medium can be combined with the appropriate liners. The resultant construction is designed to meet the size and weight requirements of the container contents. The ability of a corrugated box to provide adequate protection for a particular product under normal handling and shipping conditions is measured and checked through use of various tests.

(4)

47. The basic raw material for corrugated containers is paperboard. Paperboard arrives at a container plant in huge rolls, up to 9 feet in width, 60 inches in diameter, some weighing up to 2½ tons. The container plant normally maintains a large inventory of these rolls which vary by width and weight. The differences in weight make possible several combinations to provide for special characteristics and to meet the various strength tests of corrugated board.

(5)

48. The basic machine in a corrugated container plant is the corrugator, measuring almost a city block. It is a very expensive machine to buy, install, house and operate. Usually three rolls of containerboard are threaded into the corrugator. One liner and one corrugating medium are fed into a "single facer" which bonds them together in a single faced sheet. The single faced sheet then is processed through the "double backer" which applies the second liner, thus forming single wall (double-faced) board, that is, board with one corrugating medium sandwiched between two liners. Gluing an additional corrugated medium and liner to the single wall board forms double wall board. Adding still another corrugated medium and liner produces triple wall board. After passing through a dryer section, which sets adhesive and removes excess moisture, the combined board is given its initial scoring and is cut to size forming box blanks.

(6)

49. The initial scoring and cutting on the corrugator and the finishing operations which follow reflect the fact that each order for boxes is "tailor made" to fit the product or combination of products it will protect and to fit the distribution needs of the user. Finishing may involve cutting slots to form flaps or flanges, printing a simple identification of the contents, and forming the blank box into a container. The product is a "basic brown" box

or container, which is in wide use where utility rather than appearance is the prime consideration.

(7)

50. From this point on the container can be made as attractive or sophisticated as the user requires. It may be printed in multicolors. It may be coated or impregnated with plastic resins or wax to impart certain properties, and may be given non-skid characteristics. The box design may include such features as die cuts, hand holes or an easy opening device. Grease resistant or release properties may be added. Special design features may allow the box to be converted into a display stand or a carry home pack.

(8)

51. The finished knocked-down container is now ready to be bundled, unitized (means by which knocked-down containers are bonded to a pallet), or otherwise prepared for delivery to the user. If inner packing pieces form a part of the complete shipping container, they will ordinarily be delivered with the containers. Because the finished containers are typically shipped knocked-down, they require a minimum of storage space in the user's plant. When needed, they are then set up, packed either manually or on high speed automatic equipment, and closed.

(c) Folding Paperboard Cartons

(1)

52. Another large segment of the paperboard industry is represented by folding cartons which are the basic paperboard package for consumer products sold in supermarkets, drug stores and other retail outlets. These cartons are precision-made, low-cost packages supplied in knocked-down form. When erected they become three di-

mensional rigid packages that meet the requirements of packagers, distributors and end users. They can be handled by high speed automatic packaging machinery for companies operating on mass distribution scale (frequently at speeds exceeding 500 cartons per minute), by semi-automatic or hand-operated equipment, or by hand for smaller production and limited distribution. They lend themselves to progressive marketing and retailing methods and readily adapt to the changing needs of customers.

(2)

53. Typically these containers are printed, cut, creased, folded and often glued by CCA and shipped collapsed to the user. They are not erected until needed. These cartons help assure uniform quality and measure of the product packaged, carry the product's name and its manufacturing trademark, provide a tie-in with product advertising, serve as a product display and can promote point-of-purchase sales. They also offer many convenience features, such as easy opening, carrying handles and dispensing devices.

(3)

54. Packaged food products account for nearly half of these containers. Beverage carriers, soap, hardware and appliances, tobacco, toys, sporting goods, paper goods, and other retail uses account for most of the remainder.

(d) Composite Cans

55. The composite can involves the utilization of various materials combined in minimum but sufficient thicknesses to contain and protect a given product. Multiple

webs permit the placement of thin, high cost materials only where they are actually required in the construction, and permit relatively low cost materials, such as paperboards, to build strength and rigidity. These cans compete primarily with metal cans, approaching them in strength and durability, but generally are lighter weight and less expensive. Major markets for composite cans are motor oil, antifreeze, refrigerated dough products, frozen concentrated fruit juices, cleansers, sealing and adhesive compounds, and snack items. The composite can body or sidewall is made from heavy kraft papers in combination with other materials such as aluminum foil and plastics. Special chipboard with a high reprocessed kraft content and some foodboards are also used. The ends of these containers are composed of other materials—metal or plastics—to produce a composite container.

G.

1.

56. CCA engages in extensive product research, design and marketing research activities to create new effective packages for consumer markets. These activities are concerned with the development of new uses, improved design and more effective marketing of paperboard and plastic packaging. During the years at issue, approximately 250 people were directly involved in these activities at an annual cost of approximately $4.3-5.5 million.

2.

57. Container's Design and Market Research Laboratory, which is based at Carol Stream, Illinois, and has branches located near CCA's largest markets throughout

the United States, has earned a national reputation for its ability to perform a broad range of marketing services for its clients. These services include, among others, the assessment and development of corporate identity and marketing programs, promotional analysis and design, photography, film making, and a complete array of consumer and industrial market research services including product and package testing, consumer interviews, motivation and behavior studies, distribution studies, new product research, retail sale studies, market definitions and profiles, dealer, distributor and retail surveys. While the Design Laboratory does perform a great number of independent services, its primary responsibility is to combine its experience in market research and graphic design with the technical services of the plants and division research and development departments, in an attempt to develop "total packaging systems which function as partners to the products which they contain" instead of as advertisements pasted onto a package. Most design services performed for local accounts are handled through the Design Laboratory branch nearest the client's base of operations.

H.

58. CCA products are made only in response to a specific order by a customer. As a result, CCA does not build up an inventory of finished products as a typical business would do. CCA does have a costing manual which provides a guideline for the pricing of standard packaging designs, even though custom-made products are involved. In determining the price to be charged for a particular product, the local plant manager uses his costing manual as a basis.

plants within a single division and reported to one of three division executive vice presidents. Each vice president coordinated the activities of the plants within his geographical region, reviewed and compiled the capital requests and profit plans and had overall responsibility for each plant in this region. These men would often work with their general managers where problems arose and would work with the executive vice presidents who coordinated the operations of the entire division.

VI

ACTIVITIES OF FOREIGN SUBSIDIARIES—GENERAL

A.

61. During these years the foreign subsidiaries actively engaged in business in 6 countries, three in Latin America (Colombia, Venezuela and Mexico plus a non-operating holding company in Panama with no payroll or sales) and three in Europe (Germany, Italy and The Netherlands plus an inactive company in Austria with no payroll or sales). The Latin American subsidiaries were fully integrated, self-sustaining operational units, each obtaining to the fullest extent possible its own raw materials (local pulpwood or waste paper) within the country in which it operated and then manufacturing and selling its own packaging products designed for the local market.

B.

62. Carton International, S.A. was a non-operating holding company which held interests in Cartotechnica

Europa Carton (Italy) and eight of the Latin American subsidiaries of CCA. Carton Internacional, S.A. was formed in 1944 when CCA was initially contemplating acquisition or establishment of subsidiaries in the Latin American market. Since this type of activity would be uncommon for the paper industry, substantially riskier than domestic ventures and entail operation in political and economic climates significantly different from those to which CCA was accustomed, it was decided that any involvement would be handled through an intermediary. The non-operating holding company incorporated in Panama was designed to accomplish four basic purposes: (1) insulate CCA from shareholder liability and amenability to suit in case of possible expropriation, or contract or tort liability; (2) downplay the involvement of a U.S. corporation in the Latin American countries; (3) prevent U.S. taxation of dividends which were to be invested directly back into one of the Latin American companies; and (4) provide for the possibility that the capital needs and risks of foreign ventures may be too great, by creating a convenient means of transferring ownership of the international operations.

C.

63. Although in various countries separate subsidiaries may have performed different functions in the manufacturing and converting process, the subsidiaries in each country operated as an integrated unit. In each country with a number of CCA subsidiaries, there is generally one dominant subsidiary. This subsidiary, which is usually larger than, and often owns stock in, the remaining sub-

sidiaries, will coordinate the operations of the other subsidiaries in that country.

D.

64. All sales of finished products were made within the country where they were produced by the foreign subsidiaries except that a very small percentage of the production of the foreign subsidiaries is exported to neighboring foreign countries. The sales operations within each country were performed as a part of the total operation within that country. No sales of finished or unfinished products were made by the foreign subsidiaries to CCA or to any customer in the United States. The foreign subsidiaries did make sales in their respective countries to foreign subsidiaries or foreign operations of U.S. companies. Such customers included Colgate, Proctor & Gamble, and the producers of Kleenex, Viceroy Cigarettes, Oster, Pepsodent and Johnnie Walker. The foreign subsidiaries did not sell any products manufactured by CCA. CCA did not advertise in the foreign countries. The foreign subsidiaries performed all their own advertising and solicitation and did not advertise in the United States.

E.

1.

65. The products of the foreign subsidiaries were designed specifically for the local market; a significant part of the work of the foreign subsidiaries in each country was to design products for their local market. There were no joint marketing efforts between CCA and these foreign subsidiaries. Officers of CCA and of the foreign subsidi-

aries, who are familiar with the marketing operations of CCA and of the foreign subsidiaries, if called as witnesses in this action, would testify in their opinion that customers in the foreign countries generally relied upon the reputation developed by the subsidiaries operating in that country and not upon the reputation of CCA. There was no formal procedure or practice by which a subsidiary would request CCA's assistance in the securing of a customer. Due to the unique packaging requirements for products sold in different countries, there was little coordination in this portion of the purchasing function of commonly owned United States and foreign customers. However, where a customer is pleased with CCA's service and products, it may very well wish to use an affiliate of CCA in filling its overseas packaging needs. There have been instances where domestic customers have asked CCA to recommend packaging companies in other countries. In those instances CCA has recommended its own subsidiary where one operates in the applicable market. Absent a specific request, however, sales personnel in the United States or any other country do not make a habit of mentioning foreign affiliations. There was no instance in which CCA and its foreign subsidiaries operated under a master contract. However, there has been at least one instance where CCA did assist in the negotiation of a contract for a foreign subsidiary for the production of banana boxes, a product not produced by CCA. The foreign subsidiaries' market research was entirely independent from the market research conducted by CCA; however, CCA would provide assistance under technical services agreements upon request by a foreign subsidiary. The packaging-related research required for the products, distribution methods and consumers' habits and preferences in a particular foreign country, was markedly different from that found in the United States market.

2.

66. During the 1964-1965 period, there were design laboratories based at the following locations: Cali, Colombia; Caracas, Venezuela; Mexico City, Mexico; Hamburg, Germany and Milan, Italy. In addition, there was a small structural and graphic design department in Soest, Holland which performed only basic in-plant work for the Dutch subsidiary. There has been very little interaction between the design laboratories of each country. An exception is in Europe, where Europa Carton had a sophisticated design and market research facility which operated as a profit center and consulted all over Europe (including some work for CCA's other European subsidiaries). CCA's Design Laboratory does no market research, structural or graphic design for its subsidiaries nor does it have any direct contact with any of the subsidiaries' clients or customers, except that during these years, and for a few years thereafter, CCA's Design Laboratory did some design work for the Mexican subsidiaries. However, there would always be an employee at CCA's Carol Stream Design Lab who could suggest the use of market research techniques and recommend general problem solving procedures upon specific request by foreign subsidiaries. Also, where a subsidiary was working on a specific product and requested samples of these packages (as designed by CCA or any other domestic company) they would be sent to the subsidiary.

This type of assistance is required by the technical service agreements, for which the subsidiaries pay monthly fees. If a subsidiary decides to establish a new design laboratory, or expand the functions of an existing facility, CCA will provide assistance, but only if requested. There was no organized program to establish facilities in the different countries. Some affiliates already had established design functions when CCA acquired them; others still do not have formal design laboratories.

3.

67. As a practical matter, for companies which are marketing-oriented, such as CCA and the foreign subsidiaries, no meaningful consultation can be conducted between designers of different countries with regard to specific designs. Each country, and in fact each cultural group within a country, has its own individual character and it is this individual character which inspires the purchasing behavior of the group. Since the background of each group is different, their reaction to certain stimuli differs, and the marketing program designed for one cultural group cannot be transposed to another. However, when a subsidiary requested CCA's assistance, suggestions were given as to the use of market research techniques and recommendations were given regarding general problem solving procedures.

4.

68. In determining the relevant markets and the merchandising techniques most effective in each country, a number of factors must be taken into consideration: the state

of the economy, the degree of socio-economic stratification, the cultural background and aspirations of the people in each strata, the behavioral tendencies of the members of each strata when confronted by different stimuli, and so forth. This means that the graphic designers and market analysts charged with the development of a packaging system for a specific country and sub-group must be intimately acquainted with these factors. These varying characteristics mandate different marketing approaches for each country and therefore minimize the value of common design themes. For example, the great social and cultural differences among groups in Colombia combined with the high illiteracy rate and low income, encourage development of basic low cost packages which tend to rely on intense bold colors and typography, and daring color combinations to the low income urban dwellers. The same basic package and design characteristics can be used to appeal to low income farm dwellers, but the advertising theme may be wholly inappropriate. Indeed, in many instances these low income farm dwellers will obtain needed goods either by barter or in a local market. Formalized packaging will have no role in these transactions. Completely different structural and graphic design characteristics and themes may be needed to successfully market to the upper class urban dweller. The packaging approach in Italy must also distinguish between the rural dweller, the urban factory worker and the upper class elite. The rich cultural heritage and high aesthetic consciousness in Italy, however, dictate the use of graphics which are generally more subtle and sophisticated than those used in the U.S.

5.

69. The multiplicity of designs used in each of these foreign countries is anathema to the mass marketing approach in the United States, which generally attempts to amalgamate the entire population into a single market. This approach is feasible in the United States due to the high literacy rate, the high disposable per capita income, the relative cultural unity brought about by mass communication and transportation and the fading class distinctions which are so conspicuous in many other countries.

F.

70. The relative size of particular orders is markedly smaller in the foreign subsidiaries than in CCA. One consequence of this is that certain machinery used by CCA such as the rotogravure printer is not used in the foreign subsidiaries because its high cost can only be justified by high volume orders. The Latin American market for containers and folding cartons was primarily for prime necessities which required packaging with much less complicated inner-packaging than is typical of what CCA produced. Packaging was simpler in part for economic reasons and because the range of products to be packaged was not so diverse as in the U.S.

G.

71. No figures are available to show the relative market shares in a particular country of the foreign subsidiaries located in that country. However, those figures for 1974 are as follows (no figures are available for Germany because that subsidiary was sold by CCA in 1967). Most of

the foreign market sales figures would have been substantially higher in the years at issue:

1974 Market Shares of CCA and the Foreign Subsidiaries in Their Respective Countries

	Container Board	Box Board	Corrugated Containers	Folding Cartons	Composite Cans
U.S.	5.55	6.09	6.26	10.60	17.91
Colombia	(77% of all paperboard)		80.	25.	53.
Mexico	15.	27.	14.	22.	
Venezuela		80.	50.	30.	
Holland	—	—	7.	—	—
Italy	1.4	0.	3.5	6.	—

H.

1.

72. Pricing is established locally by the foreign subsidiaries. No pricing instructions or arrangements are made with or through CCA. There is no pricing manual utilized by the foreign subsidiaries tied in with CCA pricing. CCA has a costing manual. This is a guideline which allows plants to determine what price must be charged on a product to cover fixed and variable costs (based on such factors as grade and quality of materials used, amount of waste, required man and machine hours, etc.). When the plant management is aware of how much it costs to produce a container, it must decide what price it should charge a specific customer based on a number of purely local considerations such as: local market conditions, the importance of the customer, prices previously quoted to the customer, the percentage of capacity at which the plant is operating and numerous others. Each plant must decide for each order, the amount of markup it should

require, whether it is sufficient to break even or whether it should absorb a loss in order to obtain or retain a customer. None of the foreign subsidiaries can use this manual since raw material grades and costs and relative capital and labor intensiveness vary so greatly from country to country. Some subs have developed their own manuals; others have not.

2.

73. Due to the numerous factors involved in each calculation, CCA's costing manual may be used for custom-made as well as "standard" products. A product may be considered "standard" however only to the extent that its basic structure follows a common design (for example, one of the 26 designs listed in the "Handbook For Corrugated and Solid Fibreboard Boxes and Products" which is published by the Fibre Box Association). All products are custom-made, however, to the extent that such characteristics as: board type, basis weight, fluting, board combination, size, coating, innerpacking and graphics must be determined with regard to the particular qualities of each product and the needs of each customer.

I.

74. The management of the foreign subsidiaries was comprised predominantly of local citizens. These management personnel had complete authority and control over day-to-day business decisions. Most major policy matters were initiated by the foreign subsidiary but were generally subject to review by the subsidiary's parent, CCA. The major policy matters consisted exclusively of capital

appropriations. For example, when local plant management decided a new piece of equipment was necessary to meet anticipated future demand, to produce a new product line, to replace obsolete equipment, or for whatever other reason, the plant controller would prepare a formal evaluation of the proposed capital project. This evaluation would include such information as a description and reason for the project, practical alternatives, cost of the project, expected profit, payout and return on investment. After review by the plant general manager, this would be presented to the appropriate divisional manager of the subsidiary and in turn to the subsidiaries' Management Committee and Board for provisional approval. Upon approval, the evaluations are sent to Chicago where they are reviewed by the relevant members of the CCA "Overseas Division" (i.e., the Vice President and Controller), then submitted to CCA's Management Committee and Board of Directors for approval. CCA's reviews and approvals were required and could result in disapproval or major modifications, but seldom did. Final approval must then be given by the Board of the relevant subsidiary. (Prior to actual initiation of the project, local management must determine whether or not they will proceed).

J.

75. The books and records of the foreign subsidiaries are kept in accordance with the generally accepted accounting principles, if any, of the country in which the subsidiary is located. These accounting principles may vary in material respects from generally accepted accounting principles in the United States.

76. Except for the differences noted elsewhere in this stipulation, the machinery, products (in terms of structural design), materials and manufacturing processes used by the subsidiaries were generally comparable to those used by CCA and by other paperboard manufacturers and packagers throughout the world.

VII.

ACTIVITIES OF FOREIGN SUBSIDIARIES—BY COUNTRY

A.

Colombia

1.

Development of Carton de Colombia, S.A.

(a)

77. Toward the end of World War II, James V. Forrestal, then Secretary of the Navy, asked American industrial leaders for advice in coping with what he perceived to be a problem: the burgeoning packaging needs in postwar international trade. The President of CCA, Walter Paepcke, a personal friend of Forrestal, suggested some kind of joint action with the countries of Latin America in order to free them of their traditional reliance on foreign sources for basic materials, in this case packaging materials. Forrestal encouraged this approach.

(b)

78. After investigation, discussions and negotiations, an agreement was formalized and Carton was incorporated in Medellin, Colombia on May 4, 1944. It was financed jointly by Colombian investors and the newly formed

Carton International, S.A., CCA's Panamanian holding company. Carton International and the Colombian group each owned 50% (each putting up 50% of the capital) and the Colombian investors were entitled to name three of the company's five directors. Many of the initial details regarding the formation and operations of the company were governed by a "gentlemen's agreement" in which it was agreed that decisions would be reached by mutual understanding rather than by domination of one party over another, and that the Colombian group would direct legal work, develop personnel and undertake the sales effort, while CCA would manage the technical and financial aspects of the business. Since very little of the necessary equipment was available in Colombia, most of it was imported from the United States, and some of it directly from CCA. CCA personnel did work with Colombians and outside experts in the assembly and start-up of much of the equipment.

(c)

79. Although Carton did have a readily available labor supply, native personnel had to be trained to assume major production responsibilities. Certain key individuals were sent to the United States to study manufacturing practices in CCA plants, and some CCA employees and outside experts served as a complement to Colombian personnel for the first few years. All personnel training was, however, based on CCA's philosophy of developing nationals for any job of responsibility. In addition to CCA's initial involvement with technology and personnel training, it also supplied a portion of Carton's raw material requirements.

were conducted to find ways to reduce Carton's dependence on outside sources for basic materials, especially to reduce the imported paper for the production of bags. In 1953 pulping and refining equipment was installed in a new mill built for this purpose. Additional efforts led in 1959 to the installation of additional pulping and refining equipment to make paperboard from the native hardwood trees which, as described at paragraph 2(b) below, differed significantly from the trees used for pulp grown in the United States.

2.

Materials

(a)

83. During 1963-1965 the operations in Colombia were fully integrated with approximately 2 paperboard mills, 4 container plants and 1 folding carton plant. The raw materials for these mills were a combination of locally manufactured pulpwood and waste paper supplemented to some extent by imported pulpwood and waste paper. Some of the pulpwood and waste paper was imported from various countries, including the United States; the amount imported from CCA was nominal.

(b)

84. The content of the raw materials differed from that typically found in CCA materials, largely because tropical hardwoods were the only available natural resource. There were no tropical hardwoods in the United States. The use of tropical hardwoods as raw material for pulp required different techniques for converting it into pulp and for converting the pulp into paperboard. These techniques

were (and are) not in use in the United States. Most of the mechanical and chemical engineering work was done by Carton employees or by consultants from Forest Products Laboratories of Madison, Wisconsin ("Forest Products") a company not affiliated with CCA. Because of the hardwoods, certain equipment was specifically modified from typical paperboard manufacturing equipment; this equipment was constructed by a British Columbian engineering firm not affiliated with CCA. Not only were there the natural differences between hardwood trees and softwood trees, but there were no available homogeneous forests of a particular species of tree as existed naturally in the United States; instead an average of approximately 150-200 species of trees existed in every jungle area. For this reason the mix of fibers was substantially variegated which required different techniques in order to convert the wood into pulp. In addition, the hardwood jungle forests presented unique problems for moving the product out of the jungle. Often the trees were in the middle of swamps and, unlike tree cutting in the U.S., roads to the place of cutting did not exist. The trees were generally brought out "on-line" which means they were carried out by a line over the top of the jungle until reaching a passable road or waterway. Even upon reaching a waterway the problems were different from those generally existing in the United States because hardwoods would not float and therefore had to be moved downstream by barge.

(c)

85. In addition to the harvesting difficulties described in the preceding paragraph the tropical hardwoods required

a longer cooking process resulting in a fibre which was weaker and more brittle. In addition, there were different temperature and pressure requirements in the digesters, the woods were very dense and difficult to penetrate, and they often had exotic mineral incrustations. Most of the testing done to determine the optimum temperature, pressure, etc. requirements was done by Forest Products.

3.

Products

(a)

86. It is probable that the Colombian subsidiaries used few, if any, formulae, developed by CCA for producing paperboard or other products, nor dies developed by CCA for cutting products or printing on them. Upon request, CCA would send information to a subsidiary. Where the subsidiary wishes to adopt for its own use, a very basic die or formula based on this information, they would probably do so without further consultation. In these instances, CCA would not necessarily know whether or not the die or formula were being used by the subsidiary. These subsidiaries use the metric measuring system which presented many difficulties in the use of American machinery and specifications. Furthermore the products were substantially inferior to those produced by CCA. The use of shorter, less resilient fibers resulted in a product with a burst level (i.e., the specification which measures properties such as tensile strength, tear, stiffness, rigidity, etc.) for the equivalent basis weight which was far too low to meet the rigid American standards for packaging.

(b)

87. Approximately two-thirds of the products of these subsidiaries represented relatively standard (in terms of structural design) products which are similar to those made by CCA and other packagers in the United States and around the world; however, there were also numerous unique products produced by the subsidiaries. Perhaps the most significant product unique to the subsidiaries was a corrugated container for exporting bananas, which resulted in an entirely new concept in the packaging and distribution of bananas and led to a sharp reduction in shipping weight and spoilage. These subsidiaries also produced a multi-wall bag which is not manufactured by CCA. These two products accounted for about 15 percent of these subsidiaries' gross sales.

4.

Marketing

88. These subsidiaries had their own marketing departments which operated completely independently from CCA except to the extent, if any, that their contacts described in section V or elsewhere in this stipulation could be said to dictate a contrary conclusion. While there were common customers between these subsidiaries and CCA, the only other major sources of packaging products in Colombia were one other folding carton producer and one other multiwall bag producer; thus U.S. companies operating in Colombia (or through their subsidiaries) had very limited selection as to where they would purchase their packaging products.

5.

Personnel

89. Approximately 1500 persons were employed by the Colombian subsidiaries. The personnel department worked completely independently from CCA except to the extent, if any, that their contacts described in section V or elsewhere in this stipulation could be said to dictate a contrary conclusion. However, when the personnel department was unable to find qualified individuals in Colombia, it might consult or use the services of CCA's personnel department to locate appropriate personnel.

6.

Independent Stock Ownership

90. The 33⅓% of the stock not owned by CCA was publicly held by Colombian nationals and traded on a local exchange.

B.

Venezuela

1.

Materials

91. The operations in Venezuela were fully integrated with approximately two paperboard mills, three shipping container plants and one folding carton plant. Ninety percent (90%) of the waste paper needs were supplied by local sources. The remaining ten percent (10%) came largely from other Latin American countries and the Caribbean. Less than one percent may have come from the United States; in such cases, it would not have been pur-

chased from CCA but CCA would probably have acted as a procuring agent for the foreign subsidiary. All pulpwood requirements were imported from Canada, United States, and Europe; none was imported from CCA. Pulpwood accounts for approximately 10% of the necessary raw materials. Approximately 93% of the paperboard requirements for container plants was produced locally; the remaining 7% was imported from CCA mills and other sources. The price paid was competitive with what CCA charged third parties. All of the paperboard production of the mill was consumed by the container plants in Venezuela. All of the boxboard requirements for folding cartons were produced locally by their own mill.

2.

Products

92. It is probable that these foreign subsidiaries used few, if any, formulae, manuals, cutting or printing dies developed by or produced by CCA. Upon request, CCA would send information to a subsidiary. Where the subsidiary wishes to adopt for its own use a very basic die or formula based on this information, they would probably do so without further consultation. In these instances, CCA would not necessarily know whether or not the die or formula was being used by the subsidiary. Venezuelan subsidiaries used the metric measuring system. The products were substantially inferior to those produced by CCA. There were no governmental regulations which governed specifications for shipping containers comparable to those which existed in the United States.

3.

Marketing

93. These subsidiaries had their own marketing department which operated completely independently from CCA except to the extent, if any, that their contacts described in section V or elsewhere in this stipulation could be said to dictate a contrary conclusion. Marketing in Venezuela included research, design, advertising and public relations. Marketing departments at CCA operated as separate overhead centers, whereas in Venezuela marketing is one of the staff functions of the manufacturing operations. As indicated at paragraph VI.G. above, the rigorous competition in the paperboard and packaging industry which existed in the United States did not exist in Venezuela.

4.

Personnel

(a)

94. 1,464 persons were employed by Venezuelan subsidiaries. Each subsidiary had its own Board of Directors, the membership of which was divided equally between Venezuelans and CCA officers. Russell Wilson worked for CCA for approximately 6 years, during which time he held various positions in the production area (Trainee, Technical Superintendent, General Supervisor). He transferred to Union Grafica in Venezuela in 1962, and continued working in the production and general management areas until 1967 when he became Director of the newly formed marketing operation. He had no prior experience in this area with either CCA or Union Grafica.

(b)

95. The personnel department worked completely independently from CCA except to the extent, if any, that its contacts described in section V or elsewhere in this stipulation could be said to dictate a contrary conclusion. However, when the personnel department was unable to find qualified individuals in Venezuela, it might consult or use the services of CCA's personnel department to locate appropriate personnel. In general, key personnel were hired and trained locally. For many years, including those at issue, Venezuela had by regulation limited employment of non-nationals in a company to less than approximately 25% of the total number of employees. These regulations have subsequently been revised to impose such restrictions not only as a percentage of the number of employees but also as a percentage of salary, by geographic district of employment and by company.

C.

Mexico

1.

Materials

(a)

96. The operations in Mexico were fully-integrated with 2 paperboard mills, 1 shipping container plant and 1 folding carton plant. The entire paperboard line and packaging line was made from predominantly local materials: waste paper and mixed waste woods, the latter material not being used by CCA or any of the other foreign subsidiaries. Occasionally shortages were made up by importing these

fibers when necessary, although raw material imports would have been extremely small because of rigid import restrictions. For example, in 1965 CCA procured for Carton y Papel $1,964 of waste paper, representing less than one-tenth of one percent (.1%) of that company's cost of goods sold. Other raw materials used were practically all Mexican made.

(b)

97. In the paperboard mills the process used to produce the paperboard was different from the process typically used by CCA in that this subsidiary produced a modified soda-sulphate kraft pulp in a batch process with two small locally-made digestors. This process is not compatible with large-scale production or chemical recovery. The resulting product was not the same in yield or fibre strength as would be produced by the conventional kraft process utilized by CCA.

(c)

98. The subsidiary's corrugating medium was produced from a combination of waste paper and straw pulp. The straw pulp is made in rotary ball digestors. The use of straw in the pulping process was not used by CCA, except to a very limited extent.

(d)

99. Virtually all of the paperboard requirements for container plants were produced locally. All of the paperboard production of the mill was consumed by the container plants in Mexico.

2.

Products

(a)

100. The corrugated plants used essentially the same machinery and processes as the CCA plants for the standard container line.

(b)

101. The folding carton plant differed from CCA, in that it manufactured its own offset printing plates and did all its own photographic work.

(c)

102. Composite cans were manufactured on the same kinds of equipment as that used by CCA, but generally with less automation. Many paper cylindrical cans were produced for rolled oatmeal, an important line which CCA did not produce at all. This subsidiary also had a substantial volume in spiral-wound cores for textiles and tissue papers, which were not then and are not now in the CCA product line. Most of the composite cans manufactured by this subsidiary were not in the CCA product line.

(d)

103. Because of the predominantly waste paper raw material, the subsidiary's liner board is a different product from the typical fourdrinier kraft liner board produced by CCA. It is of a lower quality and a greater weight is required in order to achieve a particular strength. The corrugating medium is made of waste paper and straw pulp and is also a different product from the CCA medium.

The stiffness rating averaged significantly less than the minimum required for a CCA medium. CCA does not use waste paper for liner board because of the inferior quality product which waste paper produces.

3.

Marketing

(a)

104. The subsidiary's research and technical work was mainly in the area of market research. CCA's Design Laboratory did some design work for the Mexican subsidiaries during this period.

(b)

105. Products for the Mexican market were of lower quality and specifications than those produced by CCA. The Mexican products were made from lower quality fibers, had lower quality finishes on the paperboard and possessed lower strength characteristics. The requirements for packaging were also different from those faced by CCA. The Mexican market was primarily for prime necessities requiring packaging with much less complicated innerpackaging and less elaborate printing than was typical of what CCA produced. Packaging was simpler overall in part because the range of products to be packaged was not so diverse as in the United States.

(c)

106. In 1961 the management of Carton y Papel de Mexico decided to upgrade their design activities from a "primitive" problem solving function to a formal Graphics Department which would provide basic design services for the

Folding Carton and Composite Can Divisions. At that time, there were no design schools for packaging and very few corporations which trained people in this field in all of Latin America. When Carton y Papel contacted CCA, Frank Angeles, a designer of the Carol Stream Design Lab, was recommended because of his background and competence. He was Mexican born, Spanish speaking, and had experience with a number of firms. When Angeles transferred to Mexico as Art Director, he remained on the CCA payroll only to keep his benefit programs in force. In less than 10 years, however, when the subsidiary's design activities further developed into a design and market research center Angeles, who had little expertise in this area, left the organization in favor of another independent Mexican firm.

(d)

107. Very little advertising was done by the subsidiaries. The subsidiaries used only Mexican advertising agencies, none of which was used by CCA.

4.

Personnel

(a)

108. The subsidiary was in charge of its own hiring and made very little use of CCA's Personnel Department to fill key jobs. There were infrequent visits of the subsidiary's personnel to CCA installations on a spot basis; generally, the purpose was to see a specific machine or process or to discuss a specific topic with a designated person. Such visits were within the terms of the technical service agreements described in paragraph VIII.F.

(b)

109. The philosophy and practice of the subsidiary has always been to train and advance Mexican nationals to positions of higher responsibility to the extent possible.

D.

Holland

1.

Background

110. This subsidiary was originally founded in 1938 and existed as a completely independent, privately owned Dutch firm until 1958 when it was acquired by CCA. Since that time it has been managed by a Dutch management team, including members of the former management. No former CCA employees were employed by this company although 3 CCA officers are on its Board of Directors. All purchases of raw materials, supplies, machinery, and all other items needed to operate the business have been made by the subsidiary's purchasing department or by its management.

2.

Materials Used for Production

(a)

111. In Holland the subsidiary had no mills for producing paperboard. Consequently, its raw materials were rolls of paperboard and not primary raw materials. There was one corrugated container plant owned by the subsidiary which produced a quality product for the Benelux market. About 60% of the raw materials came from Dutch suppliers; the other 40% was imported from the United States,

3.

Products

115. All the products were designed by the subsidiary's structural and graphic design department and were designed for the Holland, Belgium and West Germany markets. Specifications for the products were based on metric measurements. Approximately one-half of the products were similar to those made by CCA and used in the U.S., for example, the standard corrugated boxes. In addition, there were many specialties which were unique to the Dutch subsidiary such as flower boxes for carnations, chrysanthemums, orchids and other kinds of flowers and boxes coated with paraffin for potted plants. This subsidiary also makes a single faced glassine product. Glassine is a very dense, lightweight, translucent paper such as that used in the packaging of candy. These specialty products were not manufactured by CCA. All of these boxes had to be printed in multicolors and die-cut. These glassine products, which were designed for tomatoes, biscuits and electric bulbs and accounted for approximately 10% of the subsidiary's business, were made of very lightweight single-faced corrugated materials. There was no comparable product made by CCA. In general, the design of the boxes was substantially simpler than that found in the United States.

4.

Marketing

(a)

116. The subsidiary had its own product design and development staff, which concentrated on developing boxes particularly suited for small size volume orders unique to

Holland. Most boxes were designed to be set up or assembled by hand as contrasted with the automated production of boxes and packaging typical of CCA. The subsidiary had its own testing laboratory, its own structural design department and its own graphic design department, all of which were staffed by Dutch nationals.

(b)

117. There are some years in which this subsidiary does no advertising. When it did advertise, the programs were very modest and no direction was provided by CCA, nor was there any similarity or common theme between local advertising and that done by CCA. There were no common advertising agencies.

E.

118. In general no separate information is provided herein with respect to the German and Italian subsidiaries. The German subsidiaries were sold to a Canadian firm in 1967 and CCA has had no operations in Germany since that time. The Italian subsidiaries are small and operated at a net loss for the three years in issue. The information provided with respect to the Holland subsidiary in Section D above is generally applicable to and descriptive of the operations of the German and Italian subsidiaries and the relationship between CCA and these subsidiaries; there are no differences between the manner of operation of the German and Italian subsidiaries from that of the Holland subsidiaries described above which are material to the issues in this case.

VIII

RELATIONSHIP OF CCA TO THE FOREIGN SUBSIDIARIES

A.

Personnel

1.

119. During the years at issue CCA employed approximately 13,400 persons. The foreign subsidiaries employed approximately 6,800 persons. A list of the number of employees of CCA and of each of the subsidiaries is attached as Exhibit K. It is stipulated that these figures are accurate. During the period there were 38 employees on CCA's payroll who were working for the foreign subsidiaries, most of whom were on the payroll of one of the foreign subsidiaries at some time during these years. It is stipulated that the list of employees in Exhibit C, representing the employees on CCA's payroll who were working for the foreign subsidiaries, is accurate. This figure does not include former CCA employees transferred to foreign subsidiaries who were no longer on CCA's payroll. These individuals on CCA's payroll who were working for the foreign subsidiaries were hired by the foreign subsidiaries as permanent employees, not simply for short periods of time. Of the eighteen shown in Exhibit C who were working at one of the foreign subsidiaries in January 1963 half had commenced their employment with the subsidiary in the 1950s. CCA did not have a general policy of transferring employees to foreign subsidiaries. Total payroll of CCA, of the foreign subsidiaries, and the total amounts paid

by CCA for the employees working for a foreign subsidiary were as follows:

Year	Foreign Payroll Paid by CCA	Total CCA U.S. Payroll	Total Foreign Payroll
1963	$443,752	$89,521,641	$12,894,985
1964	381,127	93,974,988	14,301,412
1965	330,057	97,757,998	15,407,405

The foreign payroll paid by CCA constituted approximately 3% of the total foreign payroll. In some instances (up to ten) CCA had no contact with these U.S. citizens prior to their being hired by the subsidiary. For example, some were living in, or traveling through, a foreign country and were hired by a foreign subsidiary. If they were to request partial payment in U.S. dollars CCA would generally oblige. CCA was reimbursed for these amounts by the appropriate foreign subsidiary. Exhibit C indicates whether the individual's responsibility was at the level of a single plant (P), at the level of a division (D) which is a number of plants producing the same commodity within a single corporation (e.g., paper manufacturing, corrugated container production or folding cartons), or at the overall corporate (c) level. The basic plant management structure is as follows:

General Manager

Production Manager   Sales Manager   Controller

Typically, general managers report to division managers who report to vice-presidents who report to executive vice presidents who report to the president.

2.

(a)

120. Transfers of CCA employees to subsidiaries are generally initiated in only one way; where a subsidiary was unable to fill a specific position locally, it might contact CCA to request assistance in finding a person with specific qualifications. CCA would generally first look within the organization because employees do have some familiarity with the industry and CCA, but more importantly, because this provides a rational basis for determining whether the individual possesses the abilities and personality traits required for success in a new position in a new country. Most former CCA employees remained partially on the CCA payroll when they began working for a foreign subsidiary. Generally, all benefits but membership in the common stock bonus plan were continued. A list of former CCA employees working for the foreign subsidiaries is attached as Exhibit D and it is stipulated that this list is accurate, to the best of CCA's knowledge and belief. It is possible there are other former employees of CCA who might have worked for a foreign subsidiary during these years. CCA believes there are few, if any, other such employees.

(b)

121. Persons who are not long-term residents of the country, whether CCA employees or not, will be selected for a position only in rare instances. From a financial standpoint, the interviewing and moving process is tremendously expensive and the computation and administration of reimbursement is costly and troublesome and

is complicated by such factors as: adjustment for cost of living differentials; the integration of non-complementary and constantly changing tax laws; and the continuation and satisfaction of various domestic benefit programs and outstanding liabilities.

(c)

122. The psychological considerations are even more important. Each individual will have different problems and each position will require different adjustments; there are some problems which are quite common however. Regardless of an individual's previous background in the language of the new country, it commonly takes up to two years before a person can become entirely fluent in the local language and familiar with local idioms, convey subtle differences in meaning and be truly comfortable in meetings. Also, aside from the necessity of learning to adjust to a new business environment, the individual must develop a completely new management style. Local business customs and procedures will often require a great degree of formality, subtlety and an entrepreneurial, seat-of-the-pants approach. In working with subordinates, the manager must learn to deal with employees who have little formal education and are extremely sensitive about their self-image. He must become accustomed to having things done slowly and must develop a tremendous reserve of patience and tact. The greatest adjustments, however, are required in the manager's personal life. It is often quite difficult to adjust to a life with fewer material amenities, cultural outlets and social opportunities. Foreigners are extremely susceptible to exotic diseases; children may have

to attend schools which are abominable by U.S. standards, and where they will always be "different" from classmates; the nonworking spouse will have a hard time meeting friends with similar interests; and in many countries, families will never adjust to the continual danger, where body-guards, guarddogs, high fences with broken glass, bars on windows, and occasional gun turrets, become the way of life.

(d)

123. Even where managers and their families can adjust to the drastically different lifestyle, a company can expect reduced effectiveness for roughly three years. Even after this period, the transplants will seldom integrate into the society, an important objective for any manager.

3.

124. The reasons why some employees of the foreign subsidiaries were on CCA's payroll varied from case to case but generally were for one o [illegible] following reasons:

(a) These employees preferred to have their checks sent to an American bank due to conversion difficulties in these countries.

(b) Several had life and accident insurance policies, were putting their children through United States schools and/or had other family and personal obligations in the United States and it was more convenient for them to pay their bills through a checking account on a United States bank.

(c) Maintaining a U.S. payroll for these employees facilitated deductions for social security and other retirement benefits. Most former CCA employees remained on the payroll in order to continue all employee benefits, except participation in the common stock bonus plan.

(d) Out of the 38 employees in Exhibit C, seven were granted options under CCA's stock plan of 1956.

4.

125. Maintenance of these foreign employees on CCA's payroll required only minimal effort on the part of CCA's accounting department. CCA was reimbursed for the service (and the payroll costs) by the foreign subsidiaries.

5.

(a)

126. During this period, CCA's foreign operations staff consisted of a part-time senior executive officer, Mr. Green; two full-time officers, Messrs. Ulvaeus and Kaufman; one part-time controller, and one part-time lawyer.

(b)

127. Mr. Green, Senior Vice President of Overseas Operations, spent approximately 40% of his time on overseas work, a portion of which was handling CCA's international legal affairs (the remainder of his time was spent as the Corporation's General Counsel). He made decisions regarding the overseas operations, but due to his limited background (no experience in sales, production or finance), and lack of intimate familiarity with the subsidiaries' affairs (he visited each country only once or twice a year)

his ability to truly manage their business was limited. He had no responsibility for every day administrative duties and did not regularly attend board meetings. With each subsidiary having total responsibility for its own performance, Mr. Green's primary functions were to oversee CCA's foreign subsidiaries and communicate requirements for compliance with CCA's standards for professionalism, profitability and ethical practices.

(c)

128. Lennert Ulvaeus, a native of Sweden who had considerable experience in the European paper industry, began in sales with CCA in 1948. Due to his background in the European market, he transferred to Europa Carton in 1956 and was promoted to Vice President of European Operations in 1963 and chief operating officer of Europa Carton. When the German operations were sold in 1967, Mr. Ulvaeus terminated employment with CCA and went to work for the new owners to manage the same German properties. Mr. Ulvaeus had responsibility for all European subsidiaries which included eighteen plants in 3 countries. Earl Kaufman, who had held a number of positions with CCA since 1933, transferred to Carton de Venezuela in 1954, after the subsidiary had undertaken an expansion program. He was named Vice President of Latin American Operations nine years later. Mr. Kaufman had responsibility for all Latin American operations which included 25 plants in 3 countries. Both of these men were on the payroll of CCA and a foreign subsidiary. To the extent they performed functions for foreign subsidiaries they were compensated by those foreign subsidiaries. Each

acted as steward for CCA's foreign interests, and liaison between the parent and the subsidiaries in their respective locales. Mr. Kaufman and Mr. Ulvaeus (except for Europa Carton of which Mr. Ulvaeus was chief operating officer) did not have responsibility for day to day administration of the subsidiaries, but both men, to an extent, were involved with major problems and long range decisions. Each reported directly to Mr. Green, a senior vice president (which is one step below an executive vice president).

(d)

129. To the extent CCA had to make decisions regarding its foreign subsidiaries, these three men presented studies and made recommendations to CCA's Management Committee and Board of Directors.

(e)

130. To the extent that CCA wished to make its opinions known to the management of the subsidiaries, these three men spoke for CCA. This does not mean, however, that CCA used them as a means of domination. CCA's policy of reaching decisions by mutual understanding rather than domination was strictly observed. Where CCA bought existing operations, especially in Europe, the prior owners generally stayed on to manage the operation for CCA. Due to their past positions, and often fierce loyalty to employees, these men would also refuse to accept domination. In addition, CCA holds local management strictly responsible for its performance. It is impossible to impose this type of responsibility on managers without giving them commensurate authority, if you wish to preserve

morale, and therefore long term performance. There is also the factor of greater government involvement in management decisions such as typically exists in the countries where the foreign subsidiaries operate. Where governments demand a voice in such decisions as plant location, capacity expansion, pricing, worker involvement in corporate decisions, worker retention and wages, the discretion of an owner is greatly reduced. Also, nationalistic governments of less developed countries do not take kindly to having foreign owners of major components of the economy imposing decisions which may or may not be in the best interest of the country.

(f)

131. Attached as Exhibit E is a list of the CCA directors and officers serving as directors or officers of foreign subsidiaries. It is stipulated that this list is accurate. In addition to the three men described above, five other CCA officers held directorships at one or more of the subsidiaries: Messrs. Chrysler, Van der Eb, Guenzel, Meier and Spachner. The first four men held positions at CCA which ranged from Secretary to Executive Vice President, and were never directly involved with the foreign operations. Mr. Spachner, who was Vice-Chairman of the Board of CCA, had been involved, with Mr. Paepcke, in the early planning and administration of the foreign operations. Except for Mr. Spachner, none of these men was familiar enough with the specific circumstances of the subsidiaries for which they were directors, to actively participate in their management, nor did they regularly visit the subsidiaries or attend board meetings although they may have voted by proxy.

5.

132. While there was no United States training program for the foreign subsidiaries' employees, there were during this period approximately 10-12 visits per year for 2-6 week periods by foreign employees to the United States to familiarize themselves with the methods of operation of CCA. These were at the expense of the foreign subsidiary. Most visits were by one person at a time. Occasionally two or three people may have visited at one time. Most of the people who made these trips were those in control functions. Occasionally, plant managers came to the United States to see how CCA plants operate.

B.

Loans

133. Occasionally CCA loaned money to a foreign subsidiary. The total loan advances from CCA outstanding at year end for the years at issue were as follows:

1963	1964	1965
$7,704,987	$7,155,714	$3,223,371

There never have been any loans between foreign operating subsidiaries in different countries. The subsidiaries also borrowed substantial funds locally. The total loan advances from financial institutions for the years at issue at year end were as follows:

Total short-term loans:

1963	1964	1965
$8,034,000	$3,140,000	$2,397,000

Total long-term debt:

1963	1964	1965
$10,562,000	$12,357,000	$12,044,000

Generally, long-term debt has been approximately one-third from United States' sources (loans from CCA and a small amount from U.S. banks) and two-thirds from local sources. Those loans from local sources were generally from: banks, insurance companies, other financial institutions, unrelated corporations, or agencies of foreign governments. Whenever practicable, financing was obtained from local sources in order to minimize the risk of currency fluctuations. For the most part CCA had no involvement in the arrangement of outside loans to the subsidiaries. However, CCA guaranteed approximately one-third of such loans.

C.

Financial Reporting By Subsidiaries

1.

134. During these years there was little profit planning. Long range budgeting consisted of a three-year forecast each year of capital projects supported by forecast balance sheets and cash flow statements. The budgets were submitted to CCA for information but not specific approval. These were usually reviewed by CCA in connection with its annual meeting. Capital projects for each year were reviewed on a quarterly basis by the Container Management Committee and Board of Directors. Final approval of the projects, however, was made by the local boards of directors of the various companies. Funds required for operations and expansions were generated from operations and, when necessary, the foreign subsidiaries borrowed funds on their own. Although there was some review by CCA management of such financing, for the most

country where the subsidiary was located. It would be impossible for Chicago personnel to decipher or analyze a mass of numbers which had no meaning to them. If CCA could not determine a subsidiary's condition by merely reviewing its financial statements, it would have been forced to take a more active role.

D.

Legal and Accounting

1.

138. During the period all international subsidiaries except Holland and Germany were audited by Arthur Andersen & Company as was CCA. Holland was audited by a local Dutch firm. Germany was audited by a local German firm. None of the international subsidiaries used the same law firms as CCA. In all cases the subsidiaries used local law firms. CCA did not use these law firms.

2.

139. Accounting procedures and methods were far from standardized although CCA worked toward achieving the most efficient systems and procedures possible.

3.

140. Tax returns to foreign governments and their subdivisions were prepared and filed locally in each country. The returns were filed taking into account only the applicable income and deductions incurred by the subsidiary or subsidiaries in that country and not taking into account the income and deductions of CCA or the subsidiaries operating in other countries.

E.

Intercompany Sales

1.

141. CCA made sales of linerboard to the foreign subsidiaries of less than one half percent of the total purchases by the subsidiaries. The largest amount of these intercompany sales was to Europa Carton, A.G. These were sales primarily of linerboard in the following amounts, which amounts represent the indicated percentage of Europa Carton's cost of goods sold.

1963	1964	1965
$203,594	$594,487	$733,780
(1.1%)	(2.7%)	(3.0%)

In general, however, Europa Carton purchased linerboard in Europe (mostly Scandinavia) and from Canada. A small percentage of other paperboard or raw material requirements of various subsidiaries was purchased by those subsidiaries from CCA. In all cases the prices paid were the same CCA would charge to other independent purchasers. In all cases those materials could have been obtained from sources other than CCA.

2.

142. One reason for the very limited inter-country sales was because materials used in the paper industry are so bulky and expensive that the cost of transportation was too great in relation to the value of the product. In addition, most of the lesser developed countries severely restricted imports as a means of protecting their foreign exchange.

3.

143. In addition to the intercompany sales, it appears that CCA purchased some paper from third parties which was sent to the foreign subsidiaries. The foreign subsidiaries reimbursed CCA. The amounts of such purchases for the years in suit are not known. For the years 1966-68 the amounts are as follows: 1966—$3,823,946; 1967—$7,357,609; 1968—$6,292,259. CCA assumes that such sales took place in the years in suit but is unable to stipulate that the 1966-1968 figures are typical of the years in suit.

F.

Technical Service Agreements

(1)

144. CCA entered into Technical Service Agreements beginning on the dates indicated with the following foreign subsidiaries, which agreements are attached as Exhibit F.

Bremer Papier Und Wellpappen Fabrik A.G. (10-23-63)
Cartoenvases de Mexico (7-1-63)
Carton y Papel de Mexico (7-1-63)
Industrias Aztlan (9-1-65)
N.V. Mercurius Golfcartonindustrie (10-1-63)
Europa Carton A.G. (10-23-63)

There were no Technical Service Agreements with any of the Colombian or Venezuelan subsidiaries since blanket agreements are not allowed by these countries. CCA did perform services for these subsidiaries, however, and was reimbursed to the extent allowed. While less developed countries frequently restrict payments to foreign affiliates as a means of protecting their foreign exchange, CCA would make book entries to reflect unrecoverable charges. Since fair market value of many of the services cannot be ascertained, charges are often computed on the basis of an apportionment of the overhead of the relevant staff department.

(2)

145. These agreements provided that CCA would offer advice and consultation to the particular subsidiary concerning manufacturing techniques, engineering, design, architecture, insurance and cost accounting. The total fees paid by the subsidiaries, including those paid pursuant to the Technical Services Agreements, were:

1963	$179,985
1964	$591,192
1965	$587,650

(3)

146. The agreements called for payments to CCA for these services based either on fixed amounts per month or a percentage of the subsidiaries' trade sales. CCA did not enter into any agreements this extensive with non-affiliated companies. There were, however, a number of less extensive agreements for technology transfers and some use by non-affiliates of specialized staff services for which they were charged amounts similar to subsidiaries. For example, an agreement might be entered into with a nonaffiliated company to transfer technology related to a specific product such as a composite can. An example is attached as Exhibit G. The subsidiary was completely free to select when it wanted to avail itself of CCA's services pursuant

to the agreement. Expenses of visits by personnel of either CCA to the foreign country or the foreign subsidiary to the United States were borne by the respective subsidiary. The subsidiaries could, and often did, approach other sources (such as local consulting firms) for information which was obtainable from CCA pursuant to technical service agreements. These local firms could be expected to understand some of the subsidiaries' problems better than CCA, which was accustomed to operating in a different environment.

G.

Purchase of Equipment

(1)

147. On some occasions CCA assisted the subsidiaries in their acquisition of equipment and machinery. Some of the used equipment was purchased directly from CCA. In general such equipment could be sold to purchasers other than the foreign subsidiaries and on some occasions used machinery has been sold to competitors of CCA or of the foreign subsidiaries. There was no formal method of notifying the subsidiaries of the availability of this equipment. In the rare instances where a piece of equipment was in good operating condition, but no longer suited to the requirements of the domestic market (i.e., it was no longer competitive due to its low capacity or was designed for a process no longer used domestically), CCA would contact a subsidiary if it was felt there may be a need for such equipment. If the subsidiary's management decided they could use machinery (CCA exerted no pressure), a sale would be arranged. During most of the period at issue, the

subsidiaries were generally charged book value plus the costs incurred in preparing and shipping the equipment. Shortly thereafter CCA used independent appraisers to determine the fair market value. Sales were then made at fair market value plus costs.

(2)

148. CCA's purchasing department also has assisted the foreign subsidiaries' purchase of equipment from independent suppliers. Generally such assistance was limited to purchases from U.S. manufacturers. Approximately 90% of the equipment purchased by the European subsidiaries was purchased from European suppliers and done without the assistance of CCA's purchasing department; approximately 10% of the Latin American subsidiaries' equipment was purchased in the same manner; the remaining 90% was purchased with the assistance of CCA's purchasing department. When CCA's purchasing department was utilized, the subsidiary would perform its own engineering studies and submit its specifications to the purchasing department and CCA would then locate the required machinery and act as an intermediary by ordering, following up and expediting. This "brokerage" function could have been performed by independent brokers, although the commission they would charge would probably be somewhat higher than what CCA charged for the services (generally 5% of the purchase price). CCA occasionally performed this function for unrelated companies. The equipment and parts purchased by CCA and billed to the foreign subsidiaries, as described in this paragraph, amounted to approximately $5-7 million per year.

H.

Miscellaneous

(1)

149. There were no common employee benefit plans, or participation between CCA and any of the foreign subsidiaries. Since 1967, all the subsidiaries have used an affiliate of the same insurance agent as CCA. This was not the case in prior years. Between 1963 and 1966 the Colombian and Venezuelan subsidiaries did use CCA's primary insurance broker. The Mexican subsidiaries did obtain some insurance from the Mexican affiliate of one of CCA's brokers, but generally used the services of a wholly local firm. The European subsidiaries used only local agents who were not affiliated with CCA's broker.

(2)

150. There were no additional intercompany licenses or royalties. Where any material right, property or expertise was provided to a company which did not pay royalties pursuant to an agreement, CCA would generally charge the recipient, whether it was affiliated or not. While similar fees were usually charged to all companies, CCA did not always charge non-affiliates for these services.

(3)

151. The United States Internal Revenue Service has audited CCA for the years in issue and accepted as accurate for United States corporate income tax purposes the net income figures of CCA set forth in Exhibit A (which figures reflect certain adjustments made during the audit). No adjustments to income or deductions pursuant to In-

ternal Revenue Code section 482 were proposed by the Internal Revenue Service.

(4)

152. Attached as Exhibit H is a speech given in 1967 to San Francisco Security Analysts by Leo H. Schoenhofen, then president of CCA.

(5)

153. The Annual Reports of CCA are attached as Exhibit I.

(6)

154. The Forms 2952, which are attached to the federal income tax returns of CCA for the years 1962-1965, as well as certain parts of the tax returns themselves, are attached as Exhibit J. It is stipulated that the figures therein are accurate.

(7)

155. Attached as Exhibit K is a schedule of the number of employees of CCA and of each of the foreign subsidiaries. The parties stipulate that these figures are accurate.

(8)

156. The parties agree that each may refer in oral and written argument to the statutory and administrative law of the foregoing countries in which the subsidiaries are located.

157. The Franchise Tax Board has audited CCA for each year subsequent to 1965, up to 1973, and has followed the same approach as in the years in suit requiring CCA

to file a combined return with its foreign subsidiaries. This combination has resulted in a proposed tax deficiency for each such year.

Dated: February 23, 1978.

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[Title Omitted in Printing]

ADDENDUM TO STIPULATION OF FACTS

The following paragraph is hereby added as paragraph 158 to the Stipulation of Facts herein dated February 23, 1978. Said paragraph is subject to the limitations and reservation of rights described in paragraphs 1 through 7 of the February 23, 1978 Stipulation of Facts.

158. In approximately 1953 a joint venture arrangement was entered into between Institute de Fomento, an agency of the Colombian government, CCA and Carton de Colombia to develop a special pulping process. Each of the participants contributed an equal share of the necessary financing. Most of the work was done by an outside engineering firm. By approximately 1963 Carton de Colom-

bia bought out the interests of the CCA and the Colombian government.

Dated: February 23, 1978.

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[Title Omitted in Printing]

SECOND ADDENDUM TO STIPULATION OF FACTS

[Filed June 29, 1979]

The following paragraphs are hereby added as paragraphs 159-162 to the Stipulation of Facts herein dated February 23, 1978. Said paragraphs are subject to the limitations and reservation of rights described in paragraphs 1 and 3 through 7 of the February 23, 1978 Stipulation of Facts. It is stipulated that Edward F. Buckler, Director of Taxes and Insurance of CCA, would testify as set forth in paragraphs 159-162 if called as a witness. Mr. Buckler has been employed in the tax department of CCA since 1960 and is experienced in working with the financial and tax information supplied by the subsidiaries.

159. The actual net income taxes paid by the following CCA subsidiaries operating in foreign countries to the taxing authorities of such countries for the specified income years are set forth in the table below. For certain of the subsidiaries in certain years (indicated by an asterisk) CCA has been unable to locate from its books and records at this time the actual tax liability paid. However, the forms 2952, attached to the Stipulation of Facts as Exhibit J, show the provisions for tax liabilities of such

subsidiaries for the specific years and those figures are set forth in the table.

	1963	1964	1965
Colombia			
Cellulosa y Papel de Colombia, S.A.	0	0	0
Carton de Colombia, S.A.	2,508,036	2,533,755	1,484,104
Venezuela			
Corrugadora de Carton, S.A.	116,282	158,130	234,542
Carton de Venezuela, S.A.	410,372	808,010	932,257
Union Grafica, S.A.	39,916	67,892	128,115
Cartones Nacionales, S.A.	5,151*	415,211	479,184
Fibras Industriales de Venezuela, S.A.	3,138*	4,583	614*
Cartoenvases Valencia, S.A.(A)	—	—	0
Mexico			
Industrias Aztlan, S.A. de C.V.(B)	—	—	0
Cartoenvases de Mexico, S.A.	951	105,383	62,374
Carton y Papel de Mexico, S.A.	310,153*	690,823	988,412
Italy			
Cartiera Europa Carton, S.p.A.(C)	0*	0	
VOSA, S.p.A.	48,374*	14,390	116,136*
Europa Carton Italiana, S.p.A.	5,162*	1,794	6,927*
Cartotecnica Europa Carton	76,688*	47,551	46,411*
Holland			
N.V. Mercurius Golfkartonindustrie	161,750	199,689	213,483
Germany			
Bremer Papier und Wellpappen Fabrik	249,720	268,504	294,500
Europa Carton, A.G.	283,225*	361,590	1,142,554
Austria			
Europa Carton Austria, A.G.	0*	0	0*

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*Figures from Form 2952

(A) Incorporated November 26, 1965

(B) Company acquired in 1965

(C) Company sold in 1964

160. As stated at paragraph 21 of the Stipulation of Facts, the forms 2952 are prepared from the books of the subsidiaries and are computed in accordance with the generally accepted accounting principles of the countries in which the subsidiaries operate. It is the belief of Mr. Buckler and others in CCA's tax department based upon many years of experience in reviewing financial and tax information supplied by the subsidiaries that the provision for tax liability shown on the forms 2952 is generally within 5 percent and not over 10% (either higher or lower) of the actual tax liability shown on the tax return filed by the subsidiaries.

161. The actual tax liability shown on the subsidiary's tax return and the tax liability shown on the forms 2952 are different in some cases because there are some differences in defining net income as between the generally accepted accounting principles of the countries involved and the income tax laws of such countries. Generally tax laws require some differences from financial report accounting.

162. The forms 1118 attached hereto for the years 1963, 1964 and 1965 as Exhibit L are part of the federal income tax returns filed by CCA for those years. The forms 1118 establish the foreign tax credit allowed to CCA in computing its federal income tax liability. Schedule B of the forms supports the foreign tax credit allowed for dividends paid by the subsidiaries to CCA. Column (4) of Schedule B states the net income of the subsidiaries computed in accordance with the income tax principles of the United

States Internal Revenue Code, i.e., the amount is calculated by including the same items of income and deduction permitted under the Internal Revenue Code. Column (5) of Schedule B states the actual income tax liability of the subsidiaries paid for the years in question to the foreign countries in which they operate. The remaining columns (6) through (11) set forth the method for determining the amount of tax paid by each subsidiary to its country of operation which may be credited against CCA's United States income tax liability.

Schedule A of form 1118 sets forth the amount of taxes of CCA withheld and paid by the subsidiaries, and in some cases other corporations, in regard to dividends or other payments made to CCA. These taxes are withheld under the laws of the particular country where the subsidiary or other corporation operates and are generally a stated percentage of the dividends or other payments made. The amounts set forth for taxes paid or accrued in Column (6) (a) of Schedule A are stated in foreign currency. Otherwise the amounts set forth in Schedule A which relate to foreign source income and foreign taxes paid or accrued and set forth in Schedule B and attachments which relate to the foreign subsidiaries' net income, foreign income taxes paid, profits and dividends are restated from local currency to United States dollars. References in Schedule A to Canada, England and Australia are in reference to the receipt by CCA of royalties, fees and dividends from independent companies which were not affiliated with CCA.

Except for the dividends the income involved was included in CCA's unitary income.

Dated: June 29, 1979.

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[Title Omitted in Printing]

No. 673492

[Filed Feb. 23, 1978]

STIPULATION RE TESTIMONY OF THOMAS M. KUCHARVY, HARRY E. GREEN AND WILLIAM P. LEE ("STIPULATION RE TESTIMONY")

IT IS HEREBY STIPULATED by and between plaintiff and defendant, through their respective counsel, that Thomas M. Kucharvy, a lawyer currently employed in the Tax Department of CCA, if called as a witness, would testify as set forth in Exhibit 1 to this Stipulation re Testimony, and that Mr. William P. Lee, who has been an officer of CCA for approximately twenty years and is currently the Assistant Corporate Controller for CCA's International Operations (a position he has held for over ten years, before which time he was Assistant Controller for Domestic Operations for approximately eight years), if called as a witness, would testify as set forth in Exhibit 2 to the Stipulation re Testimony, and that Harry E. Green, a retired officer of CCA who was General Counsel and Senior Vice President of Overseas Operations during the years 1963-1965, if called as a witness, would testify as set forth in Exhibit 3 to this Stipulation re Testimony. The parties agree that this Stipulation is to be treated as if the named individuals testified as set forth in the respective exhibits to this Stipulation re Testimony; provided, however, that this Stipulation re Testimony shall not be construed as a concession by either party of the admissibility on the grounds of relevancy or materiality of such testimony or such exhibits and the parties hereto expressly reserve the right to argue the admissibility on the grounds of relevancy or materiality of all, or any portion, of such testimony.

Further, with regard to Schedule I-IV of Exhibit I, the parties stipulate that direct costs, income and other data relating to individual plants as determined on a separate accounting basis are accurate. However, the allocation of joint costs between two or more plants, analysis of data and conclusions therefrom represents the position of CCA on this issue. The State of California reserves the right to challenge such allocation of joint costs between two or more plants, analysis of data and accuracy of conclusions therefrom based on the record.

Dated: February 23, 1978.

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EXHIBIT 1
TO STIPULATION
RE TESTIMONY

STATEMENT OF THOMAS M. KUCHARVY RE COMPARISON OF FOREIGN OPERATIONS WITH CCA OPERATIONS FOR 1974

Units of Production and Sales

Schedule I compares the fiscal 1974 operating results of all of the California corrugated plants with the results for the Cali, Colombia plant (the only Colombia plant for which information is available). Line 1 shows the number of units (Thousands of Square Feet) produced by each plant during 1974. Line 2 shows the number of units shipped. During 1974 the average U.S. CCA corrugated plant produced approximately 415,000 MSF. The average Colombia plant (excluding two extremely small satellite plants and the large banana box plant) produced approximately 235,000 MSF. While this discrepancy may tend to overstate certain fixed charges per unit of production for the Cali plant vis-a-vis the California plants, this should not be significant since many of the fixed plant charges are a function of the plant's size, and most of the fixed corporate charges are allocated in accordance with the size of the plant.

Sales Price

Line 3 of Schedule 1 shows the average sales price per MSF. While there is little difference between the prices charged by each California plant, Cali's price is 29% higher. This difference can be explained partially by Cali's higher costs of production and partially by Carton de Colombia's dominant market position (see section VI-G of the Stipulation of Facts in this suit).

Material Costs

Material costs are the purchase prices of all of the paperboard, adhesive, ink, closure materials, coatings, and other miscellaneous supplies which are used in the manufacture of the finished product (it therefore includes scrap materials). As explained in section VII A.2. of the Stipulation of Facts in this suit, Container Corporation and Carton de Colombia used different raw materials. CCA produces most of its linerboard from southern softwood pines through the use of a well known pulping process. This yields a high quality board with good tear, stiffness edge crush and burst strength (this latter characteristic being crucial in the meeting of U.S. shipping standards) per pound of basis weight. The medium which is generally used in the United States is virgin semi-chemical, which is made primarily from specific U.S. hardwoods (e.g., gum or birch). These hardwoods are more difficult to pulp and a combination of mechanical and chemical processes must be used. They yield a hard medium with good compression and flat crush at a low basis weight. A typical combined board may use two sheets of 47 lb. softwood kraft liner with individual burst strengths of 105 lbs. with a sheet of 26 lb. hardwood semi-chemical medium with a flat crush of about 60 lbs. In 1974 the average price of each MSF of this liner cost \$4.23 while one 1.5 MSF of the medium (this is the amount needed to produce one MSF of 'C'-flute board assuming a take-up factor of 1.5) cost \$3.24. The paperboard required to produce one MSF of the combined board would have weighed 133 lbs. and would have cost $11.70. This is quite close to the actual average board cost for the California plants. In Colombia, a hardwood liner which would match the burst strength of the 47 lb. softwood kraft would have a basis weight of roughly 75 lbs. and would have cost $12.43 per MSF. Colombian medium which is generally made from wastepaper has a very low compression and flat crush. If the Cali plant were to need a medium which would meet the 60 lb. edge crust of the 26 lb. U.S. medium, it would use tropical hardwood medium having a basis weight of roughly 30 lbs. 1.5 MSF of this board would have cost $7.20. If Cali were to produce a combined board which was to meet the burst strength and flat crush characteristics of the above described U.S. board, it would weigh 195 lbs. (46.6% more than the U.S. board) and cost $32.06 (274% of the U.S. board).

For most situations it is impractical, from both a package weight and cost standpoint, for packages made in, and for use in Colombia, to meet U.S. shipping standards (Colombia has no such standards). Schedule I, Line 3, Column 7, shows that Cali's board cost per MSF of production was $20.56. While this was considerably higher than the U.S. cost, it was well below that required to meet the U.S. board strength characteristics.

Variable Conversion Costs (Schedule I, lines 7-9)

Variable conversion costs consist of such factors as manufacturing labor, cutting and printing dyes, fuel and certain supplies. Manufacturing labor (Schedule I, Line 7) is the largest factor. It is composed of the hourly labor costs (including benefits and payroll taxes) incurred in the production process.

Each production facility is designed to accomplish a particular task as efficiently as possible; in the case of a corrugated plant, this is to convert paperboard into finished containers. As is the case in most manufacturing operations, this can be accomplished in a number of ways. Each plant is specifically designed in light of the relative availability and cost of each of the resources needed to produce the containers. The most important resources for purposes of this section are machinery and equipment and production employees (the costs of which are the primary components of the property and payroll factors). The relative cost of each of these resources will determine, among other things, the degree of labor and capital intensity of the particular facility. Generally speaking, since U.S. labor costs are high in relation to the cost of equipment, U.S. manufacturers continually strive toward increased mechanization of their production facilities. This situation is reversed in Colombia. Schedule III, which sketches a portion of the production process of a typical California container plant and the Cali plant, helps to explain this point.

After combined board is produced on the corrugator, it must be printed, cut, folded and sealed. In the United States these operations will generally be performed on a flexo-folder-gluer. This machine automatically feeds the corrugated blanks into a printer, makes the necessary cuts and scores, folds the container into its knocked-down form, and glues it together. At the end of this process, the containers are scanned, the defective ones are ejected, and the acceptable boxes are counted and tied into specific sized bundles—all automatically. These bundles are then transported on an electronic conveyer system to an automatic palletizer (which places the proper number of bundles on each pallet in a preprogrammed format). The pallet is then conveyed to a strapper which automatically secures the bundles to the pallet, and prepares them for shipping. In the U.S., it generally takes 5 people to operate these machines and guide the board through the system. The output, which is primarily determined by the speed of the flexo-folder-gluer, is generally about 8,000 boxes per hour of running time.

The Cali plant is operated completely differently. The combined board is first taken to a letterpress printer-slotter. The printing press, which operates on a wholly different principle and uses a different base ink than the flexographic press described above, is less expensive and requires more labor. The printed, cut and scored board will be manually removed from the machine's hopper, will be hand examined for defects, stacked on a pallet, and be carried by hand cart to the next operation. The folder-gluer will then complete the conversion operation. The knocked-down containers are again examined for defects, counted and tied into specific sized bundles—all by hand. The bundles are then carried to a stacking corner (which is two sheets of plywood joined at a 90° angle). There they are hand loaded onto a pallet which has been placed in the corner. The pallet is then carried (again by hand truck) to a semi-automatic load strapper where an operator guides the pallet to the proper position, lets the strapper apply the metal bands to one side of the load, hand turns the pallet 90°, and repeats the process. The boxes are now ready for shipping. (In some situations these last two steps may be omitted. The bundles may be individually hand loaded into trucks for immediate shipping.) This process generally takes approximately 16 employees who can produce roughly 6,800 boxes per hour.

The first station of the conversion process is the corrugator. A U.S. corrugator will usually be operated by 5 employees; the Colombia corrugator will usually be operated by 7 people (due to the lack of labor saving devices).

In Cali's production process, there are more points at which the quality of the products is examined. This is necessary since the use of inferior raw materials and older and less sophisticated equipment will produce more rejects. Due to the relative costs of labor and capital, it is more efficient to use manual rather than electronic (as is used in the U.S.) inspection systems.

Continuing Conversion Costs (Schedule I, lines 10-14)

Continuing conversion costs are those which will be incurred regardless of temporary increases or decreases in the level of production. They include such costs as salaries, administration and sales overhead, depreciation, insurance, property taxes and fixed corporate charges. Non-allocated labor, while composed predominantly of salaries and the payroll taxes and benefits attendant thereto, also includes the hourly wages of the few employees whose services cannot be attributed to the production function. As is the case with production employees, however, Cali needs more administrative employees to perform the required work. While this is partially due to the greater burden of governmental paperwork, the primary cause is the lack of employees with prior education or training. Each job is therefore broken down into a number of small repetitive tasks which require little discretion.

Fixed plant charges (Schedule I, line 11) consist of depreciation, property taxes and insurance. Depreciation, which is the largest single component of this figure, accounts for 44 cents per MSF for the California plants and 37 cents per MSF for the Cali plant (both computed on a straight line basis). Although these figures will fluctuate depending upon the level of capacity at which each plant is operating (as will all continuing costs), the difference is small. The depreciation per MSF for the Cali plant would generally be expected to be considerably less than for the California facilities. This is partially a result of the use of less sophisticated, and therefore less expensive equipment by the Colombian operation. As can be seen from Schedule III, the 1974 cost of the Cali equipment, even after adding the additional freight, crating and insurance charges attributable to shipment from the U.S. and Europe, and import duties of 20% and adjusting for the differences in capacity, is two-thirds of the cost of the U.S. equipment. This rate would generally apply to the items in Schedule III since they perform functions which cannot reasonably be performed by hand. In order to maximize employment, the Colombian government assesses progressively higher duties on equipment which will reduce manual labor or for which a substitute is locally available. Since these duties may exceed 300%, and the corporation would probably be required to retain any employee displaced by labor-saving equipment, there are effective additional "incentives" to use labor rather than capital intensive production techniques.

There are additional reasons for the lower depreciation charges. As has been noted in the Stipulation of Facts, there are numerous risks involved in doing business in foreign countries which do not exist in the United States. For most purposes of this section, these are the risks of nationalization and sabotage. Latin America is the region in which the most U.S. owned companies have been expropriated between 1960 and 1976 (Harvard Business Review, July-August 1977, Managing Against Expropriation pp. 75, 78). In order for a company to reduce its losses in the case of an expropriation, it will probably keep its investment to a minimum. If it wishes to begin operations in a country by building its own plant, it will use the minimum amount of equipment required to perform functions which cannot be done manually. It will probably purchase used, non-automated equipment, and will continue to use it for as long as practicable. It will recover as many of the costs attributable to the foreign operation as possible and will try to remit all earnings which are not reasonably necessary for the efficient operation of the business. It will try to hold reinvestment to that portion of earnings which cannot be remitted, and will lend money or guarantee loans to the subsidiary only where necessary.

As stated, used equipment will be purchased wherever feasible. (The corrugator, which combines medium with linerboard, was not included in Schedule III. Since it is the most expensive piece of equipment to be employed in a corrugated plant, it will almost always be purchased used, wherever there is a significant risk of nationalization. Due to the high cost, the comparison of either new corrugator prices or the comparison of new and used, between California and Cali, would have been distortive.) The used equipment will also be used long after it would have been scrapped in the United States. Therefore, in addition to the fact that the Cali plant would use less sophisticated and less costly equipment than the California operations, many of the depreciation charges would be based on the lower cost of used equipment and will not include any charge for equipment which, although still in use, has been fully depreciated. (Since Cali would use more used equipment and retain it longer, the use of new machinery costs from a single base period in Schedule III understates the actual differences between Cali and California's equipment costs.) Although machinery and equipment costs are generally the primary component of the property factor, the others are also material. As is the case with equipment, however, most of them are on incomparable bases from country to country (i.e., most property used in the property factor has a lower cost basis in less developed countries). For example, land in less developed, less populous areas will often be less expensive and buildings in tropical climates will often be built with lighter materials, less insulation, no air conditioning and will be constructed by inexpensive local labor.

Inventory, however, will be composed of more expensive raw materials and larger supplies will generally be retained (due to slow and uncertain deliveries).

Fixed corporate charges (Schedule 1, line 12) are the total corporate overhead expenses which have been allocated to the plant. In the case of the California plants, these include the costs of the U.S. corporate staff (i.e., industrial relations, personnel, law, tax, accounting, etc.), the operations staff (engineering and production methods, research and development, purchasing, architecture, etc.) and the shipping container division staff (marketing, research and development, etc.). Each of these expenses is allocated to the proper division (in this case the shipping container division) on the basis of the percentage of time spent for the benefit of the division (where such an allocation is practicable) or the division's conversion costs. These expenses are then allocated to the individual plants on the basis of conversion costs. The fixed corporate charges figure for the Cali plant is composed of both the allocated U.S. staff department costs (allocated to the international division and the specific plant on the same basis as they are allocated to the U.S. plants) and the Colombia staff department costs (allocated to the division and the plant on the basis of conversion costs). Since Cali is absorbing overhead from two corporations, their fixed corporate charges exceed those of the California plants. The average California plant charge of $0.81 is less than one-half of the Cali charge of $1.67. Although the amount of CCA overhead charged directly to the Cali plant in 1974 is unavailable, Carton de Colombia was charged a total of $544,767.

In order to reduce the risk that operations in 1974 are not comparable to the years 1963-1965, this analysis has focused on factors which are known to have remained relatively constant over the period such as competitive conditions, the availability of raw materials, the capital intensive operational structure in the U.S. versus the labor intensive structure in Colombia, the use of new, high speed equipment in the U.S. versus the use of used, slower equipment in Colombia and the allocation of corporate overhead between plants. It is also necessary, however, to rely on many factors which would change with the economic development and conditions of the two countries but which, due to the unavailability of historical records, could not be specifically traced. These include such factors as sales prices, material, labor, and equipment costs, profitability and productivity. The applicability of these factors, however, may be examined with regard to the context in which they were used; namely, to show relationships between the prevailing financial and economic conditions in the two markets. For example, between 1960 and 1970 the average annual growth rate of the Colombian GNP was 5.1% while the U.S. GNP grew at a 4.6% rate.[1] The differences in growth were even less when the growth rate of only manufacturing industries are considered (5.7% in Colombia versus 5.4% in the U.S.).[2] There were, however, greater differences in the rates of inflation between the two economies. After adjusting for the decline of the peso against the dollar[3] between 1963 and 74, the wholesale prices of Colombian raw materials (many of the materials purchased by Carton to manufacture its products) rose at a 5.5% rate while U.S. raw materials rose at a 6.8% rate[4], and average hourly wages increased at a 2.3% rate in Colombia versus a 4.8% rate in the U.S.[5]. (This difference, which does not include what was probably a more rapid increase in Colombian employee benefits, was distorted by a 9 percent decline in earnings of the Colombian subsidiaries between 1963 and 65. Between 1965 and 1974, of the Colombian subsidiaries wages increased by 7% annually while U.S. wages increased by 6%.) The Colombian finished product wholesale price index (which reflects the price increases of some of Carton's purchases and the containers which they sell to customers) increased at a 3.0% rate during the eleven year period while the U.S. index increased by 4.4%.[4]

FOOTNOTES

[1] 1975 United Nations Statistical Yearbook, Table 189 (Average Annual Rate of Growth of GOP at Constant Prices 1960-70).

[2] 1975 United Nations Statistical Yearbook, Table 190 (Average Annual Rate of Growth of Manufacturing Industries at Constant Prices 1960-70).

[3] 1970 and 1975 United Nations Statistical Yearbooks, Tables 185 and 194 respectively (Exchange Rates—Mid-point rates).

[4] 1965 and 1975 United Nations Statistical Yearbooks, Tables 177 and 182 respectively (Wholesale Prices—based on index where 1970=100).

[5] 1975 United Nations Statistical Yearbook, Tables 181 and 194.

[6] Schedule I information is from the 1974 Plant Reports for each enumerated location. The Colombia (Cali) reports were translated at a rate of 26.64 Pesos to the U.S. Dollar, the average of the beginning, midpoint and year-end exchange rates. Although the California information will not always correspond to that required for tax purposes (for example, benefits include all additional forms of employee compensation, regardless of whether they are reported on Federal Form 940, and depreciation is all computed on a straight-line basis), the figures for each plant are believed to be comparable.

[7] Weighted averages were computed on the basis of the average MSF produced and MSF shipped by each California plant. On this basis, Corona was assigned 23.4%, Oakland 20.5%, Fresno 19.3% and Malt Avenue 36.8%. Unit production and shipment figures, however, were computed on the basis of a straight average.

[8] For domestic plants, total employee benefits were allocated between variable and continuing costs on the basis of the percentage attributable to hourly labor (primarily variable) and salaried labor (primarily continuing). Colombian benefits were separately attributed to each category in the plant reports.

[9] Cali's plant report did not state depreciation or CCA overhead separately. These figures, as used in the Continuing Conversion Cost section of the text were specially obtained from Carton de Colombia.

[10] Wages, Benefits and Payroll Taxes Charged to Production was computed by multiplying the Schedule I, Line 7 figures by the MSF produced by each plant.

[11] A 1976 CCA study shows that for each dollar of hourly labor cost incurred by a CCA affiliated corrugated plant, payroll taxes and benefits account for 27.0% of total U.S. cost and 45.9% of the total Colombian cost.

[12] Obtained from separate CCA and Carton de Colombia reports.

[13] Schedule III traces the typical process of conversion of corrugated board into a finished, knocked down container which is ready for shipping by the Cali and an average California plant. Since specific information is not available for the years at issue, 1974 is used as an example. The 1974 Equipment Cost figure is the cost of each piece if it has been newly purchased. All figures on this page are approximations. While they are not presented for their accuracy, it is believed that this example does express the general scope of differences between the production functions of the Cali plant and the California plants for the years at issue.

[14] Income and Apportionment information is from Exhibits A-1 through A-7 of the Stipulation of Facts.

[15] Exhibits A-1 through A-7 of the Stipulation of Facts in this lawsuit.

[16] Exhibit B-2 of the Stipulation of Facts in this lawsuit.

[17] Exhibit B-1 of the Stipulation of Facts in this lawsuit.

SCHEDULE I

Sales Price and Cost of Corrugated Container Production on a Per Unit (Thousand Square Feet—MSF) Basis[6]

		Corona	Oakland	Fresno	Malt Ave. Los Angeles	Weighted Average[7]	Percent of Sales Price	Cali	Percent of Sales Price
1.	Total MSF Produced	427,965	374,322	351,941	671,097	456,331		211,778	
2.	Total MSF Shipped	429,306	376,227	352,755	675,935	458,556		212,704	
3.	Sales Price*	25.16	25.73	24.67	24.49	24.93	100	32.17	100
	Material Costs								
4.	Paperboard	12.94	12.90	12.49	12.60	12.72	51.0	20.56	63.9
5.	Other	1.19	1.26	.81	1.28	1.17	4.7	1.14	3.6
6.		14.13	14.16	13.30	13.88	13.89	55.7	21.70	67.5
	Variable Conversion Costs								
7.	Manufacturing Labor[8]	2.64	3.09	2.20	2.64	2.63	10.6	1.19	3.7
8.	Other	1.70	1.26	1.12	1.24	1.35	5.4	1.00	3.1
9.		4.34	4.35	3.32	3.88	3.98	16.0	2.19	6.8
	Continuing Conversion Costs*								
10.	Non-Allocated Labor[8]	1.76	1.96	1.73	1.93	1.85	7.4	1.18	3.7
11.	Fixed Plant Charges[9]	1.33	1.08	.88	.96	1.05	4.2	.49	1.5
12.	Fixed Corporate Charges[9]	.79	.82	.67	.88	.81	3.2	1.67	5.2
13.	Other	.50	.38	.42	.36	.41	1.7	.39	1.2
14.		4.38	4.24	3.70	4.13	4.12	16.5	3.73	11.6
15.	Inventory Charges & Other Misc. Costs*	—	(.02)	(.09)	—	(.03)	(0.1)	(.06)	(0.2)
16.	Profit Before Income Tax*	2.31	3.00	4.44	2.60	2.97	11.9	4.61	14.3
17.	Return on Invested Capital (after Tax)	14.2	23.9	35.2	22.6	23.3		42.9	

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*Denotes distribution on basis of MSF shipped. All other costs are computed on basis of MSF produced.

**Invested capital is capital stock, paid in surplus, earned surplus and long-term debt which are allocated to individual plants on the basis of conversion costs.

SCHEDULE II

Analysis of Hourly Labor Costs for Corrugated Plants

		Corona	Oakland	Fresno	Malt Ave.	Weighted Average[7]	Cali
1.	MSF Produced	427,965	374,322	351,941	671,097	456,331	211,778
2.	Manhours Worked (Hourly)	174,010	147,767	115,392	224,381	175,853	207,542
3.	Wages, Benefits and Payroll Taxes Charged to Production[8, 10]	1,127,991	1,157,395	774,303	1,772,102	1,302,790	250,338
4.	Total Hourly Labor, Benefits, Payroll Taxes[6]	1,268,430	1,494,618	883,490	1,891,772	1,469,895	250,338
5.	Average Number of Hourly Employees	94.1	83.0	62.5	111.7	92.2	80.1
6.	Manhours per MSF	.41	.39	.33	.33	.39	.98
7.	Labor Cost per Manhour	6.48	7.83	6.71	7.90	7.41	1.21
8.	Labor Cost per MSF	2.64	3.09	2.20	2.64	2.85	1.19
9.	Total Annual Cost per Hourly Employee[8]	13,480	18,007	14,136	16,936	15,942	3,125
10.	Direct Wages[11]					11,638	1,691
11.	Payroll Taxes and Benefits[11]					4,304	1,434
12.	Average Machinery and Equipment In Use (1974)[12]	2,680,984	2,080,259	2,293,045	3,219,155	2,681,010	899,838
13.	Machinery and Equipment per MSF Produced	6.26	5.56	6.52	4.80	5.88	4.25
14.	Total Property (Schedule IV, Line 4) per Total Sales (Sch. IV, Line 6)	.54	.41	.45	.36	.42	.28

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SCHEDULE III

Structure of Corrugated Plant Production Processes[13]

	Employees per Station	Approx. 1974 Equipment Cost	Approx. Average Output per Hour of Running Time
California Plants			
Flexo-Folder-Gluer	2	200,000	8,000
Automatic Bundler	1	9,000	
Automatic Palletizer	1	20,000	
Load Strapper	1	40,000	
Conveyer System (portion attributable to this portion of converting operation)		100,000	
	5	369,000	
Labor Cost/Manhour (Sch. II, Line 7, Col. 5)	7.41		
Total Hourly Labor Cost	37.05		
Cali Plant			
Letterpress Printer-Slotter	3	100,000	6,800
Bostitch Folder-Gluer (no counter/ejector)	4	50,000	6,800
Manual Bundling	3		
Stacking Corner (palletizing)	2		
Semi Automatic Load Strapper	1	12,000	
Hand Carts (3)	3	1,500	
	16	163,500	
Labor Cost/Manhour (sch. II, Line 7, Col. 6)	1.21		
	19.36		
Additional Freight, Crating and Insurance for International Shipment		13,100	
Colombian Duties (approx. 20% on this equip.)		32,700	
Additional Labor & Equipment Needed to Equalize Capacity (17.57)	3.40	36,600	
	22.76	245,900	

SCHEDULE IV

1974 Apportionment Computations for California and Cali Corrugated Plants

	Corona	Oakland	Fresno	Malt Ave.	Weighted Average[7]	% Return on Factors	Cali	% Return On Factors	Factor Totals Calif., Cali
1. Net Income Before Tax	991,834	1,128,941	1,565,711	1,755,703	1,411,803		976,689		2,388,492
Property[12]									
2. Average Owned	5,321,995	3,068,286	3,641,657	5,404,001			1,899,408		
3. Rental Expense (x8)	473,832	857,528	280,144	529,544			32,136		
4.	5,795,827	3,925,814	3,921,801	5,933,545	5,101,468	27.7	1,931,544	50.6	7,033,012
5. Payroll	1,887,194	1,894,946	1,382,233	3,070,186	2,226,667	63.4	498,161	196.1	2,724,828
6. Sales	10,799,752	9,680,795	8,703,444	16,552,448	12,282,770	11.5	6,842,155	14.3	19,124,925

	California	Cali
Apportionment Ratios for Calif., & Cali, Plants		
7. Property	72.5360	27.4640
8. Payroll	81.7177	18.2823
9. Sales	64.2239	35.7761
10. Average	72.8259	27.1741
Net Income		
11. As Apportioned	1,739,441	649,051
12. As Allocated	1,411,803	976,689
13. MSF Shipped	458,556	212,704
14. Allocated Profit Per MSF	3.08	4.59
15. Apportioned Profit Per MSF	3.79	3.05
16. Allocated Return on Sales	11.5	14.3
17. Apportioned Return on Sales	14.2	9.5
18. Allocated Return on Assets	27.7	50.6
19. Apportioned Return on Assets	34.1	33.6

SCHEDULE V

1963-65 Apportionment Computations for CCA and Colombian Affiliates[14]

		Combined Sales Factor	Combined Property Factor	Combined Payroll Factor	Average Ratio	Income Separate Accounting (000's)	Income Apportioned (000's)
1963	CCA	93.10	87.62	98.66	93.13	25,362	28,272
	Colombia	6.90	12.38	1.34	6.87	4,996	2,086
						30,358	30,358
1964	CCA	92.77	87.22	98.54	92.84	28,975	31,322
	Colombia	7.23	12.78	1.46	7.16	4,763	2,416
						33,738	33,738
1965	CCA	94.40	88.55	99.14	94.03	30,027	31,056
	Colombia	5.60	11.45	.86	5.97	3,001	1,972
						33,028	33,028

	Average Income Per Separate Accounting 1963-5	Average Income Per Apportionment 1963-5	Average Sales[15]	Return on Sales: Separate Income Sales	Return on Sales: Apportioned Income Sales
CCA	28,121	30,217	298,210	9.43	10.13
Colombia	4,254	2,158	20,955	20.30	10.30
	32,375	32,375	319,165	10.14	10.14

	Average Invested Capital[16]	Return on Invested Capital	
CCA	214,570	13.11	14.08
Colombia	20,739	20.51	10.41
	235,309	13.76	13.76

	Average Net Assets[17]	Return on Net Assets	
CCA	251,738	11.17	12.00
Colombia	25,837	16.46	8.35
	277,575	11.66	11.66

SCHEDULE VI

1963-65 Apportionment Computations for Countries In Which CCA or Affiliates Operated[14]

	1963					
	Combined Sales Factor	Combined Property Factor	Combined Payroll Factor	Average Ratio	Income Separate Accounting (000's)	Income Apportioned (000's)
1. CCA	76.67%	66.57%	87.15%	76.80%	$25,362	$27,769
2. Colombia	5.69	9.41	1.18	5.42	4,996	1,960
3. Mexico	3.56	4.48	1.80	3.28	825	1,186
4. Venezuela	3.78	6.81	2.53	4.37	2,179	1,580
5. Panama	—	—	—	—	1,412	—
6. Austria	—	.11	—	.04	(37)	15
7. Germany	6.86	8.35	5.72	6.98	1,194	2,524
8. Holland	.75	.31	.32	.46	323	166
9. Italy	2.69	3.96	1.30	2.65	(96)	958
10. Total Overseas	23.33	33.43	12.85	23.20	10,796	8,389
11. Total Combined					$36,158	$36,158

(Table continued on following page)

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	1964					
	Combined Sales Factor	Combined Property Factor	Combined Payroll Factor	Average Ratio	Income Separate Accounting (000's)	Income Apportioned (000's)
1. CCA	75.22%	67.80%	86.52%	76.51%	$28,975	$32,941
2. Colombia	5.88	9.93	1.29	5.70	4,763	2,454
3. Mexico	3.69	4.30	1.90	3.29	1,709	1,416
4. Venezuela	4.91	6.15	2.86	4.64	5,161	1,998
5. Panama	—	—	—	—	773	—
6. Austria	—	.08	—	.03	(58)	13
7. Germany	7.16	7.90	5.71	6.93	1,394	2,984
8. Holland	.81	.31	.35	.49	397	211
9. Italy	2.33	3.53	1.37	2.41	(59)	1,038
10. Total Overseas	24.78	32.20	13.48	23.49	14,080	10,114
11. Total Combined					$43,055	$43,055

(Table continued on following page)

(Table continued from preceding page)

	1965					
	Combined Sales Factor	Combined Property Factor	Combined Payroll Factor	Average Ratio	Income Separate Accounting (000's)	Income Apportioned (000's)
1. CCA	75.29%	70.51%	86.10%	77.30%	$30,027	$35,493
2. Colombia	4.48	9.11	.75	4.78	3,001	2,195
3. Mexico	4.27	4.45	2.28	3.67	2,281	1,685
4. Venezuela	5.27	5.68	3.06	4.67	5,398	2,144
5. Panama	—	—	—	—	1,673	—
6. Austria	—	.04	—	.01	56	4
7. Germany	7.77	7.13	6.08	6.99	2,791	3,210
8. Holland	.76	.30	.35	.47	431	216
9. Italy	2.16	2.78	1.38	2.11	258	969
10. Total Overseas	24.71	29.49	13.90	22.70	15,889	10,423
11. Total Combined					$45,916	$45,916

(Table continued on following page)

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	Average Pre-Tax Income per Separate Acct. 1963/64/65	Average Pre-Tax Income per Apportionment 1963/64/65	Average Sales[15]	Return on Sales: Sep. Income / Sales	Return on Sales: Apport. Income / Sales
12. CCA	$28,121	$32,068	$298,210	9.43%	10.75%
13. Colombia	4,254	2,203	20,955	20.30	10.51
14. Mexico	1,605	1,430	15,214	10.55	9.40
15. Venezuela	4,246	1,907	18,503	22.95	10.31
16. Panama	1,286	—	—	N/A	N/A
17. Austria	(13)	11	—	N/A	N/A
18. Germany	1,793	2,906	28,711	6.24	10.12
19. Holland	384	197	3,048	12.60	6.46
20. Italy	34	988	9,371	0.36	10.54
21. Total Overseas	13,588	9,642	95,802	14.18	10.06
22. Total Combined	$41,710	$41,710	$394,012	10.59	10.59

(Table continued on following page)

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	Return** on Invested Capital			RETURN ON TOTAL ASSETS		
	Average Invested Capital[16]	Sep. Income Avg. Invest. Capital*	Apport. Inc. Avg. Invest. Capital*	Total Assets[17] (1963-1965)	Separate Income Assets (%)	Apportioned Income Assets (%)
12. CCA	$214,570	13.11%	14.95%	$351,238	8.01	9.13
13. Colombia	20,739	20.51	10.62	34,010	12.51	6.48
14. Mexico	10,798	14.87	13.22	16,294	9.85	8.78
15. Venezuela	13,453	31.56	14.18	20,503	20.71	9.30
16. Panama	13,200	9.74	0	14,178	9.07	—
17. Austria	230	(5.65)	4.78	251	(5.18)	4.38
18. Germany	13,065	13.72	22.24	25,331	7.08	11.47
19. Holland	1,824	21.05	10.80	2,969	13.87	7.11
20. Italy	5,689	0.60	17.37	12,096	.28	8.17
21. Total Overseas	78,998	17.20	12.21	125,430	10.83	7.69
22. Total Combined	$293,568	14.21	14.21	$476,668	8.75	8.75

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*Average pretax income divided by average invested capital at the beginning of the years 1963-1966 (the latter figures are from Exhibit B-2 of the Stipulation of Facts.

**Average pretax income 1963-1965.

(Table continued on following page)

SCHEDULE VII

RETURN ON AVERAGE INVESTED CAPITAL*

	1963	1964	1965	% Variation Difference Between High and Low
U.S.	12.27%	13.38%	13.50%	10.02%
Colombia	26.37	21.85	13.32	97.97
Mexico	9.02	15.92	18.32	103.10
Venezuela	17.79	39.11	36.83	119.84
Germany	10.80	10.73	18.51	72.51
Holland	17.49	22.65	23.93	36.82
Italy	(1.58)	(1.01)	4.87	—

*Calculating by averaging the invested capital (from Exhibit B to the Stipulation of Facts) at the beginning and end of the year.

EXHIBIT 2 TO
STIPULATION RE
TESTIMONY

STATEMENT OF WILLIAM P. LEE RE COMPARISON OF FOREIGN OPERATIONS WITH CCA OPERATIONS FOR 1974

Of the primary operations of CCA and the foreign subsidiaries (the production of boxboard, linerboard and medium, and their conversion into folding cartons and corrugated containers), the corrugated conversion operations in different countries are the least dissimilar (i.e., the basic materials, processes and equipment are the most standardized). As a result, to the extent financial comparisons are valid between CCA and the foreign subsidiaries, the comparison of the corrugated operations is the most meaningful. I have examined the comparisons testified to by Thomas M. Kucharvy and attached to this Stipulation re Testimony as Exhibit 1, including the supporting Schedules thereto. Those comparisons have been made between the corrugated plant in Cali, Colombia and the four corrugated plants in California for the year 1974. The products being produced and the methods of operation were essentially similar for the years 1963-1965 to those in 1974. I believe, and other officers of CCA believe, that if these comparisons could be made for all corrugated plants for the years 1963-1965, the differences in productivity, hourly labor costs and unit labor costs would be at least as great, and probably greater, than those shown for 1974. However, for the European countries, the differences would not be as great as for the Latin American countries. No similar figures are available for any countries for the years in suit.

EXHIBIT 3 TO
STIPULATION
RE: TESTIMONY

STATEMENT OF HARRY E. GREEN RE COMPARISON OF FOREIGN OPERATIONS WITH CCA OPERATIONS FOR 1974

CCA's general philosophy, including the years before, during and after the years involved in this suit, was to have a substantially greater return from businesses overseas than from businesses domestically. CCA used "hurdle" rates in evaluating investment decisions both domestically and abroad. "Hurdle" rates refers to the minimum returns which must be anticipated by CCA before a new investment will be made or an existing investment will be expanded. The hurdle rates used by CCA during 1963-1965 were 10% return on investment from domestic operations and 15% return on investment from foreign operations, except that an 11-12% return on investment would more likely have been used for the safer European countries, Germany and Holland. However, it must be understood that while "hurdle" rates are the minimum returns which must be anticipated before an investment will be made, those "hurdle" rates of return generally fall below the reasonably anticipated rates of returns. CCA expected the domestic operations to yield an average after tax return on investment of between 10% and 12%; CCA expected the overseas operations to yield an average after tax return on investment of between 18% and 20%. Indeed, it was the inability of the German operations to meet these profit requirements which led to their sale in 1967. CCA felt this money could be more profitably employed in less developed countries of Latin America. In general, these greater profits have also been achieved in the years after the years in suit.

In the Superior Court
of the
State of California
In and for the
City and County of San Francisco

[Title Omitted in Printing]

REPORTER'S TRANSCRIPT OF PROCEEDINGS

Thursday, February 23, 1978

Testimony of: John C. Mc Donald

APPEARANCES:

For the Plaintiff:

MORRISON & FOERSTER
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San Francisco, California 94105
By: FRANKLIN C. LATCHAM, Esquire,
and PRENTISS WILLSON, JR., Esquire

For the Defendant:

HON. EVELLE J. YOUNGER,
Attorney General
By: PHILIP M. PLANT, Esquire
Deputy Attorney General

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Witnesses:

For the Plaintiff:	DIRECT
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THURSDAY, FEBRUARY 23, 1978

11:25 O'CLOCK A.M.

The Court: Container Corporation of America, Plaintiff, versus Franchise Tax Board, Number 673 492.

Counsel, are you ready?

And for the reporter's benefit, may we please have your appearances?

Mr. Latcham: Frank C. Latcham for the Plaintiff Container Corporation.

Mr. Willson: Prentiss Willson, Jr., also for the Plaintiff Container Corporation.

Mr. Plant: Philip M. Plant appearing on behalf of the Defendant Franchise Tax Board.

The Court: Thank you. Mr. Latcham and Mr. Willson?

Mr. Willson: We would like to introduce Plaintiff and Defendant's Joint Exhibit No. 1. I will pass the series of exhibits to the clerk.

The Court: I understand that Plaintiff and Defendant's Joint Exhibit 1 is a Stipulation of Fact with attached exhibits?

Mr. Willson: Yes. There also is in the file an addendum to the Stipulation of Fact, an additional paragraph.

The Court: There is no objection to the addendum, Mr. Plant?

Mr. Plant: No, your Honor, no objection.

Mr. Willson: With regard to that, your Honor, I have, if it will be helpful to you, an extra copy, which includes the stipulation which you just introduced, and all the exhibits, save one bulky exhibit, which it is unlikely anyone will ever look at. Would this be helpful to you to have this?

The Court: Has counsel had an opportunity to see that?

Mr. Plant: Yes. No objection.

The Court: It looks like it would be easier if the clerk keeps the original and I can have the copy to work on.

Mr. Willson: Yes, your Honor.

The Court: All right, thank you. That would be, just for the record, to keep track, that will be 1-A in evidence. And if I refer to 1-A, it is that item which will be for identification.

Plaintiff and Defendant's Joint Exhibit 1 is introduced in evidence.

1-A is for identification, and that is for the Court's copy which was presented by counsel.

1-A can be withdrawn at the end. In the event of any appeal, 1-A does not have to go with 1.

(Plaintiff and Defendant's Joint Exhibits 1 and 1-A previously received and marked for identification, were admitted into Evidence bearing the same designations.)

Mr. Willson: Your Honor, we also have a Stipulation re Testimony of several people, which will be plaintiff's exhibit. It is not a joint exhibit.

The Court: It will be Plaintiff's Exhibit 2, which is a Stipulation re Testimony. And that consists of approximately twenty-five pages?

Mr. Willson: Yes.

The Court: And as I understand it, the Franchise Tax Board, Mr. Plant, has an objection to certain portions of that stipulation based on objections of relevancy, and so on, that have been agreed may be raised by objection in submitting the stipulated statement?

Mr. Plant: That is correct, your Honor. These reservations of rights to object are incorporated in the first two pages of the Stipulation re Testimony.

(Plaintiff's Exhibit 2 previously received and marked for identification, was admitted into Evidence bearing the same designation.)

The Court: All right. Now based on our discussion, there will be a brief schedule for the submission of briefs on the issue of the objections to questions of the Stipulation re Testimony. And that would be ten days to the Defendant Franchise Tax Board to set forth their brief on the objections;

Ten days to the Plaintiff Container Corporation of America to respond;

And five days for any final rebuttal.

Then that issue is submitted subject to briefing?

Mr. Willson: Yes.

Mr. Plant: Yes.

The Court: The next item I believe is a witness to call on behalf of plaintiff.

And we indicated we could proceed with his testimony, at least as to his qualifications, so that he may be qualified as an expert before the lunch break.

Mr. Willson: Yes.

JOHN C. Mc DONALD

called as a witness by and on behalf of plaintiff, having been first duly sworn, was examined and testified as follows:

The Clerk: Your name, sir?

The Witness: John C. Mc Donald, M-c-D-o-n-a-l-d.

The Clerk: And the address, sir?

The Witness: 1098 Vernier Place, Stanford, California.

The Clerk: Thank you. Would you take the stand?

DIRECT EXAMINATION

By Mr. Willson: Q. Professor Mc Donald, will you state your profession and current position?

A. I am Professor of Finance in the Graduate School of Business, Stanford University.

Q. What has been your background in the field of finance, and training?

A. I received a Bachelor's Degree in Engineering with honors in 1960 from Stanford.

I went on to get a Master's Degree in Business Administration, MBA, with emphasis in finance, in 1961.

Then after about four years of military and working experience, I did a Ph.D. in Business Administration, with emphasis again in finance, also at Stanford. I completed that in 1967.

I have been teaching on the Stanford faculty for the last ten years.

Q. Has your training included any training in economics?

A. Yes, it does. Part of the Ph.D. Degree in the Stanford business school includes quite a number of courses also taken by the doctoral students in economics across the street from the business school, in the economics department itself.

Q. Will you tell us about your teaching experience?

A. In addition to teaching the Stanford business school, I have taught at Columbia business school in New York City, and have taught, as well, at four European business schools.

The University of Paris School, Insead, I-n-s-e-a-d;

The International Business School at Fontainebleau, France.

The French Business School called capital H capital E capital C;

And the London Business School.

In each of these cases the course material has to do with corporate financial management, which has to do with the management of businesses from a financial point of view, and with investment knowledge, which has to do with the management of investment portfolios, and an understanding of the companies that lie behind those portfolios, common stocks and bonds.

I should add, the notion of yardsticks as a financial performance, the measures by which one judges financial performance of a company is a subject included in all of these courses.

Q. What has been your experience with businesses in the field of finance and investment?

A. I have acted as a consultant to a number of bank trusts departments, with the subject of the designing of the process by which they make investments, decisions, the key topic of interest.

In addition, I have worked with about ten banks on the subject of lending decisions. That is the process by which corporate lending officers lend money to companies in the United States and abroad. About five major New York banks, and about five banks out here on the Coast.

The banks, as you know, view these lending decisions as investment decisions in terms of investing the bank's money in the businesses to which they lend.

Then I now serve as a director in six public companies. These are all corporations which are investment companies, commonly called mutual funds, which are invested primarily in common stocks and bonds. That is the securities corporations.

I also serve as a member of an advisory committee to one of the major oil companies with regard to the investment of the pension monies of the employees of that oil company.

That is a pool of capital of about nine hundred million dollars. That is an advisory role rather than running the money itself.

There are five of us on that advisory committee.

That, I believe, is the major outline of my business interest and experience.

Q. How much of this experience is foreign, international in scope, as opposed to domestic?

A. I have served as a consultant to a number of businesses that are domiciled outside the United States. Several in Europe, and one in Africa.

I think the major international emphasis comes from the fact that so many American businesses, so many businesses that are headquartered here in the United States, have a substantial part of their business abroad.

It is very common these days to find American companies that have a half or more of their profits that are earned abroad.

So the international arena, the international emphasis has become very, very important for many, many American companies of all sizes.

Q. In these various contexts then, how many companies would you say you have examined?

A. I would say the total runs into the hundreds. I have been a direct consultant to, I would say, dozens of companies.

And in the context of examining companies for purposes of investment, either common stock investment, bond investment, or lending investments on the part of banks, I think I have examined in some detail hundreds of companies.

Q. Are there any relevant publications of yours in this area?

A. I am the author or co-author of more than thirty publications that have been published in journals.

In addition, I wrote a dissertation, partial fulfillment, for the doctoral degree which I had to do with financial management, as well.

Mr. Willson: I have no further questions on qualifications, your Honor.

The Court: Do you wish to voir dire?

Mr. Plant: No, your Honor, we will accept him as an expert in the area of foreign investments.

The Court: All right, the witness will be designated as an expert for those purposes.

Mr. Willson: It will take us about two hours, your Honor. I think it would be better continuity if we could have lunch and break and come back.

The Court: I indicated I had a meeting, so if I can recess until 1:45, I should be available at that time.

Mr. Willson: All right.

The Court: Is that agreeable to counsel?

Mr. Plant: Yes. Thank you.

(Whereupon, the luncheon recess was taken.)

AFTERNOON SESSION 1:45 O'CLOCK P.M.

The Court: Dr. McDonald, would you resume the stand?

Mr. Plant: As a preliminary matter, could I make a request, Dr. Cerf, from the UC graduate school in Berkeley is here in an advisory capacity. May he have leave to sit with me at counsel table?

The Court: Yes.

Mr. Willson, you may proceed.

JOHN C. McDONALD,

resumed the witness stand and testified further as follows:

Mr. Willson: Q. Let me begin, Dr. McDonald, could you define what we mean by rate of return, or return on investment?

A. Rate of return and return on investment are phrases that refer to basic measures of business profitability.

Q. How is that determination made?

A. There are two basic classifications of definitions of rate of return.

The first, and perhaps the broadest, is a ratio that involves some measure of profit or income, in the numerator, and some measure of investment base or invested capital in the denominator of the fraction.

There may be many variations on a theme that the income may be pretax or after tax income.

And, likewise, there are many different definitions of exactly the determination of the investment base used from case to case or company to company.

But the basic notion of a ratio is a very general one.

The second category or definition of rate of return is that discounted cash flow, or sometimes called the DCF rate of return. And this, essentially is a summary figure which is prospectively looking towards summarizing the rate of return on a further sequence of cash flows or profits from a given investment.

Q. Could you give us a simple example of rate of return?

A. In terms of the first ratio that I spoke of, for example, if a company, in other words, were to invest a hundred dollars in a given project, and were to receive in the first year after tax income of fifteen dollars, then the rate of return would be 15 divided by 100, or 15 percent.

Q. What is the usefulness of the concept of rate of return to businesses?

A. The basic usefulness, I think, is to, first of all, give them a tool for measuring profitability so as to enable them to control their business.

That is the notion of financial controls says that you have to have some sort of a measure of basic profitability of the units or segments or divisions of that business. So that businesses are interested in the amount of money invested in each segment or divisions or partitions of the business, and they are interested in how much profit each of those divisions generates, and the ratio of those is the rate of return on each of those units.

So this is basically the first class of uses which has to do with financial control.

I think the second class of uses has to do with making investment decisions when there are a lot of alternatives available in a business.

This is called capital budgeting, or investment decision-making, resource allocation.

What this says is essentially you would like to, so much as it is possible, make new investments in more profitable rather than less profitable areas, if all other things are equal.

The two basic categories are financial control and capital budget or investment decision-making, in my experience.

Q. Is it fair to say companies have more uses for funds than they will have funds available?

A. I have found that it varies a lot from company to company, of course.

But in the case of very many companies, they have many more ideas, many more opportunities than they have dollars available.

Some companies have what they call a wish list, where people in the various divisions of the company come up with ideas, often not very precisely formulated at that stage, of things which might take additional investment capital, machines, new product ideas, and so on.

And this wish list can be as much as four or five or even ten times as great as the amount of money that is available.

So, generally speaking, companies have more ideas than they have money.

Q. How then does a business decide which of these competing alternatives that they will approve?

A. I think the most general criterion has to do with the expected profitability of each of those potential uses of capital on that wish list

The usual yardsticks that are used, the usual words that are used to describe these criteria vary a lot from company to company.

But in my judgment, the underlying thread running through it has to do with the expected profitability of the alternatives at hand.

The Court: You said "expected"?

The Witness: Expected, yes.

Mr. Willson: Q. Are you familiar with the term "Hurdle Rate"?

A. Yes.

Q. What do people commonly mean by that?

A. Businesses generally take the phrase "Hurdle Rate" to mean the minimum expected rate of return that is required for them to accept a new project that has been proposed by someone with the company.

So "Hurdle Rate" essentially is a minimum required rate of return of new investments.

Q. Do companies have the same "Hurdle Rates" for each of these competing investment alternatives that you described earlier?

A. Some companies do have a single "Hurdle Rate" for all investments, but a great many companies have different "Hurdle Rates" for different kinds of investment proposals.

The basic notion being many companies have different kinds of products or operations in different countries, where the investment proposals are like apples and oranges, really.

And in these cases, companies often have different "Hurdle Rates" for different kinds of investments.

Q. Could you give us an example, perhaps from your experience, of what these different "Hurdle Rates" might be? What is the magnitude of the rates?

A. I was recently talking with financial officers of a company that had "Hurdle Rates" in the range between 18 percent after tax return and 30 percent after tax return for different classes of investment proposals.

And this particular company, they divided things up into four categories:

Foreign versus domestic, and new products versus line extensions of existing products.

And the four categories went something like this:

For an investment proposal which was domestic, that is involved expenditure of capital funds in this country, and which was to be used for a line extension, that is an extension of an existing business, where they had some experience, and were already involved in, the "Hurdle Rate" was 18 percent.

And at the top of the spectrum, Category 4, were investments which were made abroad with foreign, and which were new products, that is lines of businesses in which they were not already invested.

And in between, in Category 2, you had a domestic investment in new products.

And Category 3 were line extensions abroad.

So essentially as it stepped up from 18, 22, 26, 30 percent, it went through the categories of domestic line extension, and then domestic new products, and then foreign line extension and finally foreign new products.

This is just an example of four different "Hurdle Rates" used by a single company.

Q. Would you say this approach is typical, companies perhaps might divide it up differently, but the approach of having different "Hurdle Rates"?

A. In my experience, many medium and large size companies do now have multiple "Hurdle Rates."

And the general approach, this general approach, is used in most of these companies.

The exact way they describe the categories and the exact means of assigning one sort of investment to one sort of category or another obviously varies from company to company.

But the notion of a range is rather general, in my experience.

Q. The specific "Hurdle Rates," could we find those in publications?

A. Generally one could not find those in publications. These "Hurdle Rates" are regarded by the companies that I know as proprietary information, the sort of thing they don't like to reveal to competitors, and they don't like generally to reveal this in their financial statements, although there are instances of some companies that have actually put a "Hurdle Rate" or more in their annual report.

This is relatively rare, in my judgment.

So that one doesn't go to the library to find those kind of numbers, but rather one comes to this through actual contacts with companies.

Q. Have you specifically looked to see recently if there is published information on this point?

A. My perusal of journals as they come along, and with my working not far from the Stanford business school library, has led me to conclude that there is relatively little in the published record about the actual multiple "Hurdle Rates" that companies use.

There have been a few articles that are indicative of the subject by mentioning "Hurdle Rate" in the title.

But once you read these articles, they are relatively general, or they come from relatively small samples of companies, to which companies have replied with rather sketchy data.

Q. In your experience, how do the "Hurdle Rates" compare as between the United States and the rest of the world?

A. Generally "Hurdle Rates" are higher for investments to be made abroad than for investments to be made by American companies here in the United States.

The simplest way of dividing it up is to think simply of domestic versus foreign.

And in that case, the foreign "Hurdle Rates," in my experience, are generally higher than the "Hurdle Rates" that are applied for similar line of businesses here in the United States.

The next step that some companies have used is to divide the world up into domestic, and then foreign industrialized countries, which have a somewhat higher "Hurdle Rate" generally than the domestic American situation.

And thirdly, foreign less developed countries, or developing companies, which is a still higher "Hurdle Rate."

Even this three part classification is obviously crude, because there are lots of differences among countries in industrialized categories and the development category, as well.

Q. Switzerland is often regarded as a haven for capital, a safe place to put your capital.

Would you say that Switzerland is less risky, in that there would be a lower "Hurdle Rate" in Switzerland than in the United States?

A. No. My experience is that "Hurdle Rates" are generally higher, even in Switzerland, than in the United States.

But the general impression has some validity. That is during the World War, and the impression of people in many countries in Europe and in the Middle East, and the Far East, as well, Switzerland is a relatively safe country, and I think that impression is valid.

But compared to the United States, which is a much larger country, a much more diversified country, because of all the attributes that we understand in general terms and my impression has been that both American and Swiss-based countries regard the United States as being less risky than Switzerland, and that the margin is to require a lower "Hurdle Rate" here than they do in Switzerland.

Q. Have you reviewed the Stipulation of Facts in this case, Plaintiff and Defendant's Exhibit 1?

A. Yes, I have.

Q. You will recall that Container has operated subsidiaries in three Latin American companies, Venezuela, Colombia and Mexico.

Where would you currently place those countries in this "Hurdle Rate" comparison?

A. In terms of the structure that I outlined a few moments ago, I would put those three countries in the foreign developing category.

Q. And where would you place the operating subsidiaries in Europe, specifically Italy, Germany and Holland?

A. I would put all three of those countries in the foreign industrialized country category.

But I should add that Germany would be rather near the top of the industrialized country category, in the sense that it would be closest to the United States.

And Italy would be near the bottom, I think, in the sense that it would be furthest from the United States.

Q. How would you compare the changes in the difference between the relationship—the differences in the relationships in the "Hurdle Rate" through the years 1963 through '65 as compared to the present time?

A. Well let's take the United States first, and look at American companies as they have set "Hurdle Rates" for domestic investments.

Generally over the past ten or fifteen years, companies have raised their "Hurdle Rates." And, at the same time, many of them have raised their "Hurdle Rates," as well, for foreign industry.

So that one general statement that one can make is that, in my experience, companies generally have higher "Hurdle Rates" today than they did fifteen years ago.

But as regards that required return in foreign countries, it depends a lot on the foreign country.

But one example which might illustrate this would be a company with which I am familiar, that in 1965 had a spectrum of "Hurdle Rates" running from 15 percent to 25 percent. And today they have a spectrum of "Hurdle Rates" going from 20 to 30 percent.

Q. Are there any countries where the gap had widened in the intervening years between '63 and '65 as compared to now?

A. I understand your question to mean a gap between "Hurdle Rates" required domestically and that in foreign countries?

Q. Yes.

A. And I think if you look at examples like Peru and Chile, those countries are generally viewed as being riskier today than they were ten or fifteen years ago.

Q. Any European countries that might be riskier today than they were fifteen years ago?

A. Yes, I would think many countries view Italy as being riskier today than it was fifteen years ago, because of the political changes there.

And some even regard Great Britain as being riskier today than fifteen years ago.

Q. Would there be any countries where the gap has lessened?

A. Yes, I think there are.

I think if you compare domestic investments invested in Germany, which has grown and diversified and become much stronger in the last fifteen years, you find that gap between the domestic investments and investments in Germany would reflect a somewhat narrowing spectrum of "Hurdle Rates."

I think the same might be true of Japan because of the development there.

And the perception that the basic underlying risk of the economic and political system in those countries is less today than it was fifteen years ago.

Q. What would be your expectation for the future?

A. My expectation is there will continue to be a spectrum.

As I look out over the next decade or generation, the United States, because of its size and because of its relative political stability, and because of its institutions, all of those things that we know to be the economic and social and political stability and power of the United States, will continue to make it the lowest risk place in the world in which to invest.

The Court: Gentlemen, I have received another group of questions from the jury we have out.

You were just about, I think, through with this particular thought on the spectrum?

Mr. Willson: Yes.

The Court: Did you have another question?

Mr. Willson: Yes. One question, and that would be a nice stopping point.

The Court: All right.

Mr. Willson: Q. These five points, then, would you expect that these differences between foreign countries and the United States will be worked out in our lifetime?

A. No, I would not think they would be in our lifetime. There will be many changes country to country abroad.

But my general expectation is that all foreign countries will continue to have "Hurdle Rates" in the years ahead, at least in our lifetime, which will be somewhat higher in the United States than they are today.

Mr. Willson: This is a good place.

(Proceedings interrupted.)

The Court: Back on the record. The testimony in the Container Corporation of America versus the Franchise Tax Board.

And Dr. Mc Donald is on the stand.

I want to thank counsel for their cooperation.

We have to do that sometimes to accommodate the jury.

Mr. Willson: Q. By way of transition, Dr. Mc Donald, could you give us another example that illustrates the difference between "Hurdle Rates" between the United States and abroad for similar investments?

A. Take an example of a copper company that is considering proposed investments in mining operations.

One company with which I am familiar is willing to approve new investments in Montana, for example, which have an expected return of 15 percent after taxes.

But in today's situation in Peru, they are not willing to approve a somewhat similar investment in expanding mining operations there, even though it has an expected return of 30 percent after taxes. The reason being that the risk in Peru is obviously much greater.

The actual return might be in excess of 30 percent, but it could also be negative.

So the "Hurdle Rate" for new investments in Peru is just much higher than for new investments in Montana and the United States.

Q. This is not necessarily the anticipated return in Peru, but simply the minimum return which they must expect to get in order to even consider making such an investment, is that correct?

A. Yes, minimum expected return is exactly what I mean by the phrase "Hurdle Rate."

Q. Have you ever seen a higher "Hurdle Rate" in the United States or similar investments than in a foreign country by the same company?

A. No, I never have. Not for similar investments.

Q. So would you expect that the "Hurdle Rate" would be higher not only on the average in the rest of the world as compared to the United States, but also that for each country the "Hurdle Rate" would be higher than in the United States?

A. Yes, I would. For similar lines of business or similar investments, yes.

Q. So again, are there any places where you would expect a "Hurdle Rate" to be lower than in the United States?

A. No. In my experience, "Hurdle Rates" are higher in every country outside of the United States than they are in the United States.

As I mentioned, the spectrum varies from country to country.

But I would say in every country, they are higher than they are in the United States.

And so for the average of foreign countries, as a whole, or for the average of industrialized foreign countries, or for the average of developing foreign countries, this "Hurdle Rate" is higher than it is for the United States.

Q. Are there any differences in "Hurdle Rates" within the United States? For example, as between California and Alabama?

A. In my experience, there are not. Not for similar investments anticipated or examined by a single company.

Q. Have you ever seen a company that had a higher "Hurdle Rate" in one part of the United States than they had in another part of the United States for similar investments?

A. No, I have not.

The companies that I am familiar with generally apply the same "Hurdle Rate" for specific kinds of business in all of the states of the Union.

Q. Why not? Why wouldn't you expect to find any differences?

A. It is my opinion that the reason for this uniformity for an existing company in a specific line of business throughout the United States just has to do with the great commonalty that one faces throughout the country.

We have a common legal system, and a common language.

The important political risks that one thinks about when one makes investments are generally the same throughout the United States.

It is not to say that there are not occurrences from time to time that may be different from region to region or state to state, but it is simply to say these are not in the same ballpark as the differences one sees when you compare the United States with another country.

And in addition to that, if they do exist, they are not only small in my experience, but transitory. That is to say they don't last. So we see rationale in the similarities with respect to risk.

We can understand this uniformity of "Hurdle Rates" for similar investments by a given company in different parts of the United States.

Q. Do I understand that the basic reason for greater "Hurdle Rates" abroad and in the United States is the differences in risks?

A. Yes, that's correct.

Q. Before we discuss what those risks are, which I would like to come back to, let's turn for a moment to actual rates of return as compared to these anticipated or minimum anticipated rates of return.

That the evidence that companies have a higher "Hurdle Rate" because of the greater risks, is there any empirical evidence that the relationship between risk—that there is a relationship between risk and actual rate of return?

A. Yes, there is. This was a debate in the field of finance and economics that went on very actively in the 1930s and 1940s.

The question was something like this:

Given that there is a higher expectant rate of return for a higher risk, is there also, on the average, and on the whole, a higher actual rate of return that is associated with a higher level of risk bearing?

In the first launched study that addressed itself to actual rates of return and how they related to risks, as I understand the literature, it was a study done by Brad Hickman based on all the large issues of the corporate bonds in the United States in the years 1900 to 1945.

This study was published by Professor Hickman for the National Bureau of Economic Research.

What he looked at were risk categories of bonds in accordance with their ratings.

The highest rated bond is a Triple A bond, and the second is a Double A, and the third is an A, and so on.

It was clear that the promised yield on lower rated bonds, that is high risk bonds, was higher.

And the question that Professor Hickman addressed in his very large sample of time was, was the actual rate of return on this large sample of bonds, particularly after the terrible years of the Depression, when many bonds did default, if not totally, they were slow in their payments of principal and interest, after all of this default experience of the Depression, was the actual rate of return, after all is said and done, still higher for the lowered rate or the higher risk bonds?

From what he found was that after taking into account all of the nuances of this study, that there was an actual rate of return for risk bearing.

That is to say the Hickman results and the debate that followed the Hickman results established that riskier bonds, those are lower ratings, not only have a higher promised yield, but after all was said and done, on the average and on the whole over a series of years, and over a great number of different issues, there was a higher realized return.

So this confirmed the thought that many economists have had, as well as people in business and finance, that people not only expected to be rewarded for risk bearing, but, on the whole they were rewarded for risk bearing.

Q. Is there any empirical evidence in the equities market as opposed to the bonds?

A. Yes. Yes, this evidence came later.

These were studies in the 1960s and in this decade, 1970s, which studied large samples of common stocks in the United States that have been classified prospectively, that is at the beginning of each period, that is as a measure of risk which was somewhat comparable to the bond ratings that had been used in the Hickman study.

And the question again was, after a great number of years, and across a large sample of common stocks, do riskier stocks over time give a higher actual rate of return, given the fact that many of them are companies that get into trouble, and a few of them give negative rates of return.

And the finding of these studies has generally been that on the average, and on the whole, riskier equities, like riskier bonds, give higher actual rates of return.

It is the impression of people in my field of finance that there is, over time, not in every stock, and not in every year, surely, but over a variety of stocks and a variety of years, there is an actually higher rate of return for riskier stocks than there is for lower risk stocks.

Q. Is it reasonable to draw a parallel—you are drawing a parallel between riskier bonds and riskier stocks and the actual returns.

Can we extrapolate from that to an investment in Venezuela as opposed to making an investment in the United States?

A. I think there is a parallel. And I cite the bond and stock studies, because they are in the public domain, and are very large samples of data.

They are studies that have been done by careful research.

In the case of companies, what we are talking about is bonds and stocks are assets in the portfolio of institutional and individual investors. And these project investments, like a copper mine, in a foreign country versus the United States, or a manufacturing operation in Venezuela versus California, is an asset on the balance sheet of a company. So that there is a parallel.

I should emphasize that these rates of return on companies, individual projects, and individual units, are generally taken to be confidential. We simply don't have parallel studies of individual products, actual rates of return versus expected, within individual companies that are directly comparable to the stock and the bond market.

But I think the parallel between the two is positive and unmistakable.

Q. To summarize at this point, you are stating, if I understand it, that when you net out profits and losses on more risky investments, you will end up with a higher net return than netting of profits and losses in less risky investments?

A. That is correct.

Q. Thus, is it your experience that in the normal case, a multinational corporation, it will earn a greater return in its foreign investments than it will earn in its domestic investments?

A. Yes, I think that is the case. And one should emphasize again that this higher expected and higher actual rate of return is not obtained in every country in every year.

Because if it was higher abroad in every country and in every year, then there would be no risk.

Precisely what risk is, the fact that there are disappointments in some years, and certainly disappointments in some countries where substantial losses are sustained.

But if you aggregate all of the foreign operations of most companies, I should say most financial companies, such as banks, as well, you find that there is a profitability of foreign operations across all countries, an average, over time.

Very often larger than not on the domestic operation.

Q. What are the actual rates of return within the United States? Would you expect to find differences?

A. Yes, I think that actual rates of returns in a given year may obviously vary across operations in different parts of the country.

But this is not to imply that the "Hurdle Rate" or the expected sustainable rate of return should vary from region to region.

Take a simple example. For those McDonald hamburger stands that are owned by the parent company, some of those stores, some of those restaurants in various parts of the country in a given year are much more profitable than those in other parts of the country in a given year. Indeed, in one part of the city some restaurants may be more profitable than others owned by the company.

But it is often difficult to keep a high rate of return a secret. And either other competing companies, or perhaps even the company itself, is likely to take advantage of those opportunities which look most promising in the short run, and this tends to equilibrate those returns over time.

So the heart of the matter is those actual returns in a given year may vary over various regions of the United States, but it is not the sort of variances that we would expect to last, and it certainly is not in the ballpark, I think, of the kinds of differences that one observes within the United States—between the United States and foreign countries.

One simply cannot compare Alabama and California as you can compare California and Peru.

Q. Those differences that actually occur then within the United States, is it fair to say that they would be short-grown differences, short-termed differences?

A. My experience has been that they are relatively short in term, yes.

Q. And one of the reasons for that would be mobility of capital?

A. I think that is true. Within the United States, with our freedom to travel, and our freedom to move one's person and his family and his machines around the country as the opportunities appear greater elsewhere, this mobility of human beings and capital, because of the freedom to move across the states, the common language, relatively common customs, and so on, means that if I am earning 10 percent in California, and I think on a similar business I can own two or three times as much in Idaho, I may even move to Idaho, or certainly expand the Idaho operation rather than the California operation.

It tends to equilibrate things.

There was recently an example of a small business down on the Peninsula, where this individual became frustrated over the years because of union problems and higher wage settlements, and higher local taxes, and other problems, and finally just packed up his equipment in his little operation owned trucks, and physically moved it up to Idaho.

This kind of a move one would not expect to be made between the Peninsula and a foreign country very often as people are able to move among the states.

I suppose a more dramatic example would be to move the textile industry out of New England into the Southern states.

This sort of mobility does exist within the United States to a far greater degree than it exists between countries.

Q. Is there any correlation between interest rates which financial institutions would charge in the various locations as between the United States from the rest of the world?

A. Yes, there is.

And I think the way one should observe that directly is to look at interest rates charged on Eurocurrency loans, all of which are denominated in dollars.

Q. Can you tell us what Eurocurrency loans are?

A. Eurocurrency loans, as I speak of them here, are loans that are made by U.S. and other banks out of London, which is the center of this kind of lending, denominated in dollars, and made directly to foreign governments.

Countries may use these borrowings to finance their balance of payments, deficits, for example.

And these interest rates are not reported in the New York Times, but they are in the public record in terms of financial publications.

And what one sees is that the interest rates charged for given maturity of loan by a syndicate of the world's banks to a developing company, the banking system has to take a higher risk, is simply a higher interest rate than that which they charge to the larger industrialized nations.

And I should stress that these loans for the banks are investments. That is from the banks' point of view, the interest rate or the all-end yield is their e[illegible]ted rate of return, and they demand a higher expected rate of return in making loans to Zaire than in making loans to France, for example.

Q. Is the difference only the inflation problems?

A. The inflation problem washes out, because the loans are made in dollars, and the interest and principal is repaid in dollars.

So the relative rate of inflation, which is an important variable from country to country, and which affects the rate of devaluation or revaluation of one concern versus another.

This inflation currency adjustment problem washes out of the consideration, because the loans are made and repaid in a foreign currency.

That is why I used the example of Eurocurrency loans to various countries, so that we can keep it all in dollars, and keep it in a constant currency.

Q. Is there a parallel between lending to foreign countries and lending to companies in those foreign countries?

A. Lending officers of major banks that make these loans feel there is a direct parallel.

That is to say the risks that one sees in lending to a company in a given foreign country are often parallel to risks one sees in lending to the central bank of that country. And the reason is simply because the underlying political situation is so terribly important, both for the perceived risk of the country itself, the ability of the treasury to honor its interest and principal payments on time, and the ability of major companies within that country to honor their promised interest and principal payments on time.

So the underlying factors are those which are political and economic.

Q. You testified as to those Euro market loans.

In your own personal experience, or your professional experience, have you also observed differences in the interest rates at which banks would lend money outside the United States as opposed to in the United States?

A. In my experience, banks generally expect to make more money abroad than they make in the United States.

They pay very careful attention to what they call country risk, and to the amount of loans that are being made, and they are held outstanding in each country.

The reason is that they do business in many, many countries of the world. These countries do differ with respect to their risk exposure.

Banks do suffer losses from time to time, and these riskier loans are not honored.

And the most recent examples are the defaults in Zaire and the defaults by the Turkish government. And because of this, banks keep very careful track of the expected and the actual returns that they are making in terms of these interest rates in various parts of the world.

They view them as being more profitable in an expected sense, but they also perceive them as being riskier.

Q. And they charge higher interest rates abroad than they do here?

A. Yes, they do. And particularly after you adjust for differences in exchange rates so that you get a comparison of apples and apples.

That does not confuse loans in Brazilian cruzeiros as compared with loans in American dollars.

That is, you must keep it in a constant comparison.

I think they do apply both to businesses abroad and to loans to the central banks, to the countries themselves.

Q. Are there parts of the United States where you would expect banks to charge a higher interest rate than in other parts of the United States to a similar company?

A. Banks regard the United States as a national market. And larger banks that do business in many parts of the United States have a single prime rate which is quoted in the paper every day.

Now 8 percent, which they extend to the highest quality borrowers, whether they be in Detroit or in San Francisco or in New York or Atlanta.

So we do have a national market, and there is for companies, I should stress, of the same size, same credit worthiness, the same interest rate, regardless of their geographic location.

Q. You testified earlier that the basic reason for these greater "Hurdle Rates" in foreign countries is because of risk, is that right?

A. Yes, risk is the central factor.

Q. Could you categorize what these risks are?

A. Categories of risk are often taken to be arbitrary, in the sense that different individuals will clarify the risks in slightly different ways.

But generally speaking, there is broad agreement what these risks are, although the language used to describe them, they obviously differ from person to person.

I think there are three very large categories that most banks think about and most large corporations consider.

Those are catastrophic first.

And second, risks associated with economic state.

And, third, political risks broadly defined.

Q. Let's take a look at those individually.

Perhaps we should start, and if you can explain, what are the catastrophic risks?

A. The catastrophic risks are fundamentally politically rooted in nature. Companies worry. Latin American companies worry in particular about expropriation.

The experience of the American copper companies in Chile, that is a prominent example that will not be forgotten in our generation.

And smaller companies than that have been nationalized or expropriated, as well.

What we are talking about here is involuntary loss of ownership or control, or both, without payment for that expropriation. That is the unilateral or highly restrained negotiations, so that you do not get paid the total market value of your investment, and you are taken out against your will.

So catastrophic, in the sense that it tends to end the business as it was envisioned when you went into it.

Q. What about your second category, risk, what economic state?

A. By economic state, I mean that the economic makeup of countries does differ just enormously across countries, as compared to the United States.

The striking thing about the United States is not only that it is so large economically, but that it is so diversified. So many different kinds of products and industries.

As you go to much smaller countries, these countries very often are dependent for their balance of payments for their exchange earnings on a small number of products.

For example, Peru depends importantly on the exportation of copper and fish. And many of the anchovies are simply not there as they were some years ago.

Similarly, Zaire is in trouble today because of the low price of copper, as well. These are not well-diversified economies.

They may have a lot of people with good will in the countries, but they are subject to buffeting of commodity price and other economic changes, many of which are beyond their control, and these changes don't get averaged out the way they do in a larger economy.

So by economic state, I think about the size of the economy, economic diversity of the economy. Those things which constitute the whole portfolio of the activities in small countries as opposed to larger industrialized countries.

Q. What about devaluation risks, are those economic state risks?

A. Yes, I think that one can consider currency changes as part of the economic picture. What devaluation or revaluation simply refers to the changes in exchange rates as between any two currencies.

For example, between the Zambian kwacha and the United States dollar.

Q. Your third category of risks with political risks, will you elaborate on those?

A. Political risks range from the catastrophic, the ones that make the newspapers from expropriation, down to many kinds of political risks which are much more day to day and much more less dramatic, but certainly no less real for the companies that have to do business there.

Many have to do with restrictions on business. These are not unknown in the United States, to be sure, but they are much more complex and much more difficult to predict often in foreign countries.

I am thinking of the tendency of many foreign governments to change the rules of the game once companies are in under a given set of rules that may have appeared to be quite a reasonably profitable investment.

Under a new set of rules, under a new regime, it appears to be much less profitable.

By "rules of the game," I mean the whole set of restrictions and guidelines under which a business operates.

To be specific about this, they might involve various kinds of controls, price controls, for example.

Q. Price controls is what you mentioned?

A. Yes.

Q. What do price controls mean?

A. Price controls are simply the control or the influence that governments and regulatory bodies have over prices of various kinds of goods and services as opposed to letting the prices be set by the free market system.

Price controls are not unknown in the United States even today, but they are much more generally imposed abroad, and much less predictable in my experience in many foreign countries than they are in the United States.

A second category, perhaps even more trouble than the first category of restrictions, has to do with restrictions on labor and the policy towards employees, and the way policy towards employees is handled in many countries.

For example, in many foreign countries, it is much more difficult to layoff employees in a period of slack and recessions than it is in the United States. So there is a constraint on the ability of a business to cut back its operations when it would seem financially desirable to do so.

In addition, it may be difficult for companies in some countries to terminate employment, or even to shut down an operation and pull out all together without the permission of the government.

Plant openings, plant closings, plant movings, many of these decisions which are taken to be the domain of the business management in the United States are highly restricted by governments in other countries.

I think the second major category has to do with the constraints on labor and other kinds of employees.

Q. Are there any other restrictions, repatriation problems?

A. I think a third category does have to do with restrictions on the remittance of earnings to the United States. These rates of returns that are earned abroad often are not convertible immediately into dollars and able to be repatriated to the United States.

Many countries have restrictions on the percentage amount of earnings that can be repatriated.

And for those earnings that are left within the country, often they have restrictions on how they may be reinvested.

So the returns once earned are not so freely directed from foreign operations as they are from the domestic operations.

Q. You mean by that you may actually earn money in another foreign country and not be able to get the money out of the country back to the United States?

A. That's correct. One might earn, one might invest a hundred dollars and earn fifteen dollars in income, and find that they can only repatriate two of those dollars, for example, to the United States, and that the remaining thirteen could only be reinvested along the lines of rules set up by the government.

So it is not true that a return is a return. It depends where it is earned and what the constraints are, and what you can do with the money.

Q. Any import restriction differences recognizable as between imports into foreign countries and into the United States?

A. Many foreign countries have restrictions on imports and have tariffs that are much more extensive and much more complicated, and often far larger than those in the United States.

It is not unheard of to have tariffs of 300 percent on the importation of machinery. For example, to a foreign country, machinery which might be used to replace labor, so-called labor-saving investments. Simply it is the desire of the people in those countries to try to sustain employment for those people who are now working.

So I think there is a whole complex of restrictions which the people who run foreign country governments see as being in the national interest, which may conflict with the best interest of the American companies who seek to do business there.

Q. The Stipulation of Facts in this case, on page 65, and paragraph 130, comments on this, CCA's own experience, mainly governmental involvement in plant location, capacity expansion, wages, and worker participation in decision-making, and so forth.

Does your own experience bear out, confirm with the experience related in the Stipulation of Facts?

A. Yes, it does. I was not all surprised to read those facts.

Q. Are there any differences in the risks within the United States?

A. Yes, I think there may be differences from time to time and region to region, but they are not in the same ballpark as the larger differences so often existing between the United States and foreign countries.

So that the order of magnitude of the risk differences between countries, and the United States and many foreign countries, is simply larger than that between states.

Also, it is my experience that whatever risk differences do exist among regions of the United States, that these risks are often transitory in their difference. They are simply are not by the events as they evolve.

It is because we are basically, with all our differences, one great United States, a single country.

Q. Would the situation ever stabilize within the United States, in your view, with risks higher in one region than another?

A. I cannot imagine that it would.

Q. You testified earlier that the textile industry moved out of New England and into the South. Doesn't that indicate that greater return must be higher in the South, and we could expect it to permanently be higher in the South?

A. I think the answer is yes and no.

It exists that the rate of return on operating in the South is sufficiently higher to warrant the move out of the New England states.

But note how the adjustment process works, and I think the textiles are regarded as a classic example of regional change.

The movement of companies from the North to the South has served to bid up wages in the South. Bargains in land are more difficult to find now than they were before.

And so I would imagine many of these textile companies both expect to and did realize higher rates of return in the South than they did in New England. But the very active mobility of this capital, the movement of these enterprises has tended to drive down the realized rates of return in the South as the price of land and wages, and so on, is bid up, and to make New England relatively more profitable.

And it is because of this that there are some examples lately of companies moving to New England because of the situation now in wages and in land values that now look more attractive.

This process has been going on for a very long time in the United States, and I would expect it to continue.

Q. You testified in talking about political risks a lot of those risks seem to come down to differences between the makeup of the government, the people, and the system.

If that is true, why then would we have a different risk situation as between Great Britain and the United States, Great Britain having a similar democratic tradition, and so forth?

A. I think there are many similarities between Great Britain and the United States. The most obvious ones have to do with language and the parliamentary system of government, which are so similar in many respects.

Great Britain is not a place where you can expect to find the kind of fighting in the streets that one observes in some of the developing countries.

That is it is a system of law and order similar to the United States in many respects.

But there are differences that I recall, jointly political and economic, that are profound between Great Britain and the United States.

The struggle between the two major parties in Great Britain and the nationalization of so many major industries in Great Britain, I think the steel industry is the best example, has induced in the British system a great deal of uncertainty about what the future for Great Britain will hold.

Many of those risks that were foreseen for Great Britain have been reduced a little bit by the inflow of oil from the North Sea. But that great country has in its political consensus many aspects of uncertainty about the Britain of the future that the majority foresees.

So that while there are many similarities between the United States and Great Britain, I think there is less a consensus in its political economic sense in Great Britain than the United States, and it is because of that, and the labor situation being somewhat more difficult in Great Britain than the United States, that one saw for so many years the refusal of American firms to invest in many cases in any more money in Great Britain until the situation changed.

So it is not a criticism of the whole great country of Great Britain, and it is not in any way an attempt to paint them with the same brush as Peru.

When one says there simply exists in Great Britain, because of its political-economic situation some risks that do not exist in the same extent in the United States, they are comparable, but they are not identical.

Q. Are there any other reasons for the higher "Hurdle Rates" internationally than in the United States other than risk?

A. In my experience, risk is the heart of the matter.

Businesses talk about these differences in a language that varies just enormously from business to business. They talk about strategic considerations. They talk about motivation of securing market shares. The language may be that of marketing, or production or finance.

People talk about it in very different language.

And often, in my experience, it really comes down to risk in the end. That is, the way it is described may vary enormously. But the differences that are implied by higher "Hurdle Rates" abroad as opposed to the United States really come down to these fundamental differences in risk, which have to do with political and economic structure.

The Court: I am sorry. When you get to a logical area here, I do have a matter with the jury, and I want to give the court reporter a few minutes.

Mr. Willson: Just a couple of minutes.

The Court: All right, fine.

Mr. Willson: Q. Did these international risks, differences, exist in the years that ensued in our case, 1963 and 1965?

A. Yes, I think they did.

Q. Any differences?

A. "Hurdle Rates" were higher abroad ten to fifteen years ago as they are today compared to the United States.

As I stated earlier, there have been changes from country to country.

I mentioned, I think, decreased risk in Germany of investments, vis-a-vis the United States, and Japan, vis-a-vis the United States, and the increased risk in investments in certain Latin American countries with political and economic problems.

So the basic spectrum existed then, as it does today, but there are differences from country to country.

The spreads may narrow or widen, but the basic structure existed then as it does today.

Q. How long have these risks conditions been going on, the differences in risks?

A. I think that they have certainly existed for a very long time.

Obviously if you go back a century or two, you have a situation where the United States was a developing country and Great Britain was a great industrial power.

It is just likely in the 19th century the situation could have been reversed. So I don't mean to imply that it was ever thus, but rather over the great part of the century, certainly during World War II, these broad relationships have held.

Q. So you suppose in some period of time that the positions of Great Britain and the United States have switched in terms of which is the less risky place?

A. I think they have, as the population has grown in the United States and surpassed Great Britain, and we now have what we call the Gross National Product, which was not a phrase used in the 19th century. It has grown in the United States and surpassed Great Britain. The two countries have crossed in terms of size and importance.

And in the structure we are talking about today, one could have said a hundred years ago, or a hundred and fifty years ago, that the reverse could have been true in terms of "Hurdle Rates" being lower within Great Britain than they are in the United States as a young country.

Mr. Willson: This is a good place to break, your Honor.

The Court: All right, fine. It will take about ten minutes or so, and you may step down, Doctor.

(Proceedings interrupted.)

3:53 O'CLOCK P.M.

The Court: Now we take up the civil case again.

I believe, Mr. Willson, you stopped off your examination when you were talking about the year '63 to '65 where the "Hurdle Rates" were higher today.

Mr. Willson: Q. On risk conditions, Dr. McDonald, you testified that they have been going on for a long time, the differences in risk between the United States and other countries, is that right?

A. Yes, it is.

Q. And you expect those differences and risks to continue into the future a long time?

A. Yes, I do.

Q. Do you expect those differences and risks to be worked out in our lifetime?

A. No, I do not. I would think that it is fairly clear that between now and the end of the century it will continue to be substantial risk, there will continue to be substantial risk differences between the United States and the total economy, the foreign countries we are talking about today.

Q. Do you expect the actual rates of return, differences in rates of return will continue for a long time into the future?

A. Yes. I think we can realistically expect that companies doing business in the United States and abroad will continue to earn on the average and on the whole higher rates of return abroad than they do in the United States.

That is to say that not only will we expect rates of return to continue to be higher in foreign countries than they are in the United States, but that average actual rates of return will continue to be higher, as well, in foreign countries than here in the United States.

Q. Is it fair to say that in your view more rational businessmen would invest in a foreign country with an expectation of a lower rate of return than he could get for a similar investment in the United States?

A. Yes, I think that is correct. I think no rational businessman would invest money abroad at higher risks and lower return, provided that rate of return was realistically calculated over some long time horizon over the life of the entire project.

I think it is just simply not the everyday rational business decision to invest money without getting paid, hoping to get paid on the average for the risk that you will have to bear.

Q. You have testified that the "Hurdle Rates" are higher in the rest of the world than they are in the United States for the reason that the risks are greater in the rest of the world than in the United States, and also the companies have been, and you expect they will continue to achieve greater rates of return abroad than they achieve in the United States, is that correct?

A. Yes, that is true on the average.

Q. Let's turn to how these greater rates of return are actually achieved.

And I wonder if you would tell us what the major reasons are that enable companies to achieve greater rates of return in foreign countries than they achieve in the United States?

A. Well, the number one factor has been lower payroll costs in foreign countries than has been the case in the United States.

Wages in the great majority of manufacturing industries and a per hour, on a per year basis, are lower abroad than they are in the United States.

And you add into that fringe benefits so as to get the total labor cost again on a per hour or per employee year basis.

And a great majority of industries and great majority of countries, these wages are simply lower abroad than they are in the United States.

Q. Don't you expect that the workers abroad are generally less efficient and less productive than workers in the United States?

A. That is true. They are generally less efficient than they are in the United States, in the sense that it takes more labor hours generally to produce a given unit of output abroad than it does in the United States.

This lower efficiency abroad than in the United States tends to reduce the difference between the lower wages abroad and in the United States in terms of what businessmen normally call unit costs.

Unit costs is the total labor cost per unit of output.

But despite this difference in efficiency, the fact remains that unit costs in the great majority of industries in great majority of countries are lower abroad than they are in the United States.

Q. What differences might you expect to find generally between foreign and domestic operations which are a result of these lower payroll costs abroad?

A. In my experience, the basic common sense of most businessmen is that where unit labor costs are higher, there is more pressure to automate. In general, there is more pressure to use machines and automated process than to replace labor.

And on the contrary, when the reverse is true, where unit labor costs are relatively lower, there is a tendency to try to use labor rather than machines, or use labor plus lower technology, older machines rather than labor plus high technology machines, as is generally the case in the United States.

So the point of all this is that the production process and the combination of workers and machinery is, in part, determined by wage costs.

And so what one finds is in countries with much lower labor costs, there is a much more labor intensive design of the work process.

It really affects the way the business is set up in the first place.

Q. We are talking here about how it is that businesses achieve greater returns, and you testified the lower payroll costs is the first and primary factor by which they achieve great returns in foreign markets than they do domestically.

What other factors are there?

A. I think businessmen often talk about the inputs in industry, protection they sometimes get in foreign countries.

We talked earlier about the restrictions which are of political or economic nature that countries sometimes place on the businesses which are within their frontiers.

On the other hand, there are sometimes some benefits which they bestow in terms of these barriers of keeping out the kind of free competition that normally you would be exposed to as a business that is already there.

So the infant industry protection notion, which is really, I suppose, in origin an economic phrase as much as a business phrase, and is a notion that it may be viewed as being in the national interest of that country to have a given industry so that they will be more autonomous as opposed to simply importing that goods, and to nourish the so-called infant industry along, and they will set up protection barriers that enable that business to do better than it otherwise would in getting started in the total exposure to the winds of free competition.

So this serves to enable those people who are there to do better than they might do with full competition.

Q. Is an additional factor that the economies in these foreign countries are often growing at a faster rate than in the United States?

A. When you look at growth and demand for the product, that depends, in part where business in general in a country, are the real growth of the economy. I mean the growth of income and output in that economy after you adjust for inflation.

And the fact of the matter is that developing countries are in a stage of their own growth which is at a higher slope of growth than for industrialized countries like the United States.

And many places with higher real growth enables companies to sell into a demand for higher growth of product, which leads to not only higher profitability, but higher growth in that profit path, as well.

In the language of business, I often hear businessmen talk about the real growth potential abroad as opposed to the United States, that is higher growth in foreign markets versus domestic markets as one of the ways by which these high rates of return that they expect might be realized.

Q. What about, I often hear that businesses will have a larger share of the market in a foreign country than they will have of the market in this country. Is that a factor?

A. It is generally a factor, yes. Market structure, market shares vary a lot from industry to industry, as well as from country to country.

But if one can be generalized, I think it is that in many smaller countries, and, again, less diversified than the United States, companies in a given industry, in that stage of the country's development, are able to build up and retain a larger share of the total market than they might be able to in the United States.

And the feeling among many businessmen is that a higher market share leads to a higher profit margin and to a higher return on investment.

Market structure or share is part of the anatomy of the production of profits through which returns are achieved and realized.

Q. If you had in a particular foreign country highly competitive conditions so that it was easy for a new investor to get into a particular industry, and you did not have as large a market share, would you still expect that the actual returns would be greater in the country?

A. Yes, I would. And it is a key point, I think.

Because the question that I often hear in business is under free competition, that is without this sort of protectionism that I spoke of earlier, would it be the fact that new entries in that market and additional competition would bring these rates of return down so that they might be no higher than they are in the United States?

And I think the answer is that even under free competition, this would probably not occur. That is, the conclusion is that because of the higher risks for all the economic as in political reasons we have already discussed, in foreign countries as opposed to the United States, that the entry of new business, the entry of new businesses into that market, would stop short of the point of driving returns down to the level that generally one would find in the United States and in lower risk areas.

So the way I would express it is that, even under competition, you would get to a kind of unequal, where greater returns are both expected, and, on the average, actually realized in that smaller, less-developed country, than they would be in the United States in a similar industry.

Q. Dr. Mc Donald, you have reviewed, have you not, what is called Stipulation re Testimony?

A. Yes, I have.

Q. And as part of that, you have reviewed the testimony which would have be given, or it is there, of Thomas Kucharvy, and William Lee and Harry Green, which are the three individuals named in that Stipulation re Testimony, is that correct?

A. Yes.

Q. With regard to the testimony of Harry Green, which is Exhibit 3 to the Stipulation re Testimony, would you say that his indication of "Hurdle Rates" and anticipated rates of return used by Container Corporation is comparable to what you would have expected and comparable to what you have been testifying to?

Mr. Plant: Your Honor, at this point, to make the record clear, the Franchise Tax Board would like to register a continuing objection, if possible, to any testimony given by Dr. McDonald to support the matter set forth in the Stipulation re Testimony, for the very same reasons that we have set forth in the preamble to that stipulation, and with agreement of counsel and the Court, not consent, and we would like to address any arguments as to relevancy and materiality in our briefs, not only to the matter set forth in here, but any testimony of Dr. McDonald along the same line.

Mr. Willson: Agreed.

The Court: I think that would be well noted.

The Court will accept the testimony at this time, but in the event the objections to certain testimony in the Stipulation re Testimony were sustained, then the Court would review Dr. McDonald's testimony in that light; to wit, a premise upon which he made a statement based on Mr. Harry Green, Dr. Harry Green's testimony as to weight or other reasons, if the Court sustains the Franchise Tax Board.

Mr. Plant: Thank you.

The Court: The same is to the opinion of any other expert; to wit, if there is a basis of fact supported by the evidence.

Mr. Willson: Should I restate the question?

The Court: Do you have the question?

The Witness: Please restate the question.

Mr. Willson: Q. The question is, in having reviewed the statement by Harry Green, namely that "Hurdle Rates" are defined by him to be the minimum returns which must be anticipated before an investment will be made, and also he discusses, he contrasts that with reasonably anticipated rates of return which are higher than "Hurdle Rates," since "Hurdle Rates" are defined as a preliminary rate of return, and he states there during the years in question

CCA expected the domestic operations to yield, and after tax return on investment, between ten and twelve percent, and the overseas operations to yield, and after tax, return on investment of between eighteen and twenty percent.

And my question to you is, is this comparable to what you would expect and to what you have been testifying to?

A. Yes, it is.

My experience in relationships with other American companies is similar with this statement in many respects.

Above all, there is a higher "Hurdle Rate" for a foreign investment than domestic investment.

And secondly, that the anticipated return, that is the average return you hope to make is somewhat above the minimum or the "Hurdle Rate" in both cases.

So I think the relationship generally holds in the companies with which I am familiar.

Q. Exhibit 1 to the Stipulation re Testimony is Mr. Kucharvy's testimony. And there are a series of schedules attached to his testimony.

And, for the record, Dr. McDonald has a copy of those schedules with him, and I would like him to refer to those schedules.

Mr. Plant: No objection.

Mr. Willson: Q. As to Mr. Kucharvy's testimony in the schedules, how do they define or measure profitability of these operations?

A. The basic bottom line measure of profitability is return on investment.

The return on investment, once again, is a measure of profit divided by a measure of the investment base. It is the ratio we have been discussing here today.

Q. Is that the generally accepted way to calculate return on investment?

A. I think it is the generally accepted way of calculating return on investment.

I should emphasize once again that there are many variations on a theme. Both in the definition of profit, in the enumerator, and in the specific definition of investment base in the denominator.

I think the important aspect of my experience has been though not the variety of variation on a theme, but the general similarity that it is a measure of profitability in the enumerator investment base, in the denominator and the motivation in the use of this ratio is to determine profitability per unit of investment.

Q. Mr. Latcham tells me I said Schedule 1, and I meant Schedule 6.

I take it you are referring to Schedule 6?

A. Yes, I have been looking at Schedule 6, and I have been referring to return on invested capital or rate of return on Schedule 6.

Q. You just testified that there are some variations on this theme in terms of how you might define invested capital or define profitability.

If you make those variations, or adapt some of those variations, is it fair to say that as long as it is done consistently, you would anticipate whatever ranking it gives you to be the same?

A. Yes, I think that is the heart of the matter. Whatever ratio definition you use applied consistently within the company, that is that a comparable set of numbers would be used in calculating the profitability across different segments of the business.

So that while many companies vary in their definition, all the ones with which I am familiar try to stick to one measure once they come up with it, and apply it consistently in different parts of the business.

Q. All right. If we could take a look at Schedule 6 now?

What do those figures demonstrate? How should we interpret those?

A. In my judgment, the most striking inference that I would draw from these numbers on Schedule 6 is that the average return on domestic investment over these three years was 13.1 percent, whereas the average rate of return on foreign businesses over the same three years was 17.2 percent.

That is to say that the actual average rate of return achieved on foreign businesses was higher than monetary percentage points per annum than the rate of return on the domestic business.

Q. Is the difference between 17.2 percent and 13.1 significant, would you say?

A. I take it to be quite a significant difference. It is a percentage term of one-third higher, nearly, abroad than in the United States. And four percentage points per annum is a very substantial number, indeed, to a finance man or a businessman.

Q. Turning to Schedule 7, which calculates return on average invested capital for the six operating countries, and what do we find to be instructed there?

A. I think the key findings that I would draw from Schedule 7 is that the return on invested capital in the United States was basically more stable over these three years than it was in any of the foreign countries in which the company had operations.

You see that only Venezuela had a higher rate of return than the United States in every single year, but that is what you would expect. That is precisely what higher risk normally means.

Sometimes it is higher in the United States, and sometimes lower than the United States, but, on the average, you expect it to be higher.

And I think that that shows the relationship between the numbers in effect on Schedule 6 and 7, in the sense that Italy, for example, a lower rate of return than the domestic return.

Germany had an average rate of return over these three years which was approximately equal to the domestic return.

The other four operating countries had average rates of return that were higher than the United States.

The total for all six of the operating countries averaged over the three years was higher than the United States. That is this number of 17 versus 13 percent.

So this serves to emphasize that it is the average foreign operation and the average over the number of years that one would expect to be higher.

If it were always higher abroad, then there would not be the higher risk that we talked about this afternoon.

So I think averaging over time the number of years, such as this three-year period, and averaging over a number of foreign operations, is just fundamental common sense, as most businessmen would see it in trying to understand this relationship between risk and return between foreign and domestic operations.

Q. Schedules 1 to 4 relate to a single aspect of CCA's business for the year 1974, not for the years ensuing, in that they compare the corrugated operations, the corrugated container plants in Cali, Colombia, with the corrugated container plants in California.

In looking at those schedules, Professor McDonald, what can we learn about why the returns that you previously testified to were higher for CCA's foreign operations than their domestic operations?

A. I think the breakdown of data in Schedule 1 and 2 show three or four major items that contribute to this higher realized return in this example of comparing Cali, Colombia, to operations in California domestically.

The first item that strikes me is on Schedule 2, line 7, which shows the labor cost per man hour for the average California plant as opposed to the plant in Cali, Colombia.

And we see that the average labor cost per hour is six times as high in California as compared to Cali, Colombia.

Then on the next line you see the labor cost per MSF, which is the unit labor cost per thousand square feet of output.

And you see that that number is roughly two and a half times as high in California as it is in Cali, Colombia.

The difference between that two and a half and the six is simply the effect of productivity that we were talking about earlier.

Wages, per se, are only one-sixth in Cali as to what they are on the average in California, but the California laborers are more productive and more efficient when combined with their machinery.

So the net of that is that the unit labor cost per unit of output is still more than twice as high in California as it is in Cali, Colombia.

I think that the payroll item I just mentioned is the most striking.

I think a second item, which is also important, is shown on Schedule 1, line 3, and that is the sales price.

The sales price per unit is higher in Colombia than it is in the United States.

And looking down the same page, you see on lines 4, 5 and 6, that the material cost, that is that the input materials to the production process are also more expensive in Colombia than they are in the United States.

So that the net of those two, is that their material cost is higher, and the sales price that they sell it for after processing it is higher, as well.

The payroll and sales price and material costs are the first two items.

The third item is depreciation. You see that on Schedule 1, line 11. These fixed plant charges are the sum of depreciation insurance and some other fixed charges.

But the key finding here is that depreciation and other fixed charges in Colombia is only one-half of what it was in California.

I think that is illustrative of the situation of using the older machines or fewer machines, less capital intensive process or labor intensive process than one would find in California.

So that lower depreciation charge, the lower production price in Colombia tends to give a higher return, as does a lower labor cost.

And the final item I think is the line 12, Schedule 1, which shows what they call fixed corporate charges.

I take this to be the corporate overhead to the two operations.

It seems to me to be stated quite conservatively, in the sense that they allocate more than twice as much overhead to the Cali, Colombia, operation per unit of output than they allocate to the average California operation.

Well, the sum total of all four of these factors that I mentioned, which are payroll, sales and materials, depreciation, and other fixed charges, and fixed corporate charges where overhead is to produce a higher profit per unit in Colombia than is produced in California.

This line profit for income tax is seen as line 16 on Schedule 1, and this number works out to be 4.61 for Cali, Colombia, versus 2.97 for California.

That is the sum total, if you like, of all these differences in prices and costs.

Then when you divide profit by invested capital to get return on invested capital or rate of return, you see that the combination of all these factors leads to a higher return on invested capital in the foreign operation and in the average operation in California.

Q. I want to emphasize that the figures on this schedule you have been talking about are for 1974. The years in suit here are the years 1963 through 1965.

Exhibit 2 to the Stipulation re Testimony is a statement by William Lee that he believes that if these comparisons could be made for all the corrugated plants for the years 1963 to '65, the differences in productivity, hourly labor costs, and unit labor costs, would be at least as great, and probably greater than those shown for 1974.

Based on your experience, would you expect that that is correct, namely, that the differences in magnitude on these items would be as great in the year '63 to '65 as they appear to be in the year 1974?

Mr. Plant: Your Honor, I would object to that as being outside of the scope of the witness' expertise.

I believe that the figures generated in this schedule are based upon accounting procedures, it involved variables, some of which I believe it is recognized herein or admitted, which would render it almost impossible for Dr. Mc Donald to say with any degree of certainty what the situation might be peculiar to CCA's operation for the period in controversy.

The Court: Mr. Willson?

Mr. Willson: Well, I would like him to answer the question, and I think it is within his expertise. He is a man who spent a great number of years analyzing financial data. In the large measure, that has been his living.

He has analyzed the data here, and I am asking him to extrapolate from 1974 back ten years earlier.

Mr. Plant: We do not question his ability as an expert in foreign investments. We question his familiarity with specific accounting procedures, and his knowledge of specific variables, which may or may not have been taken into account in this particular schedule which would reflect in one way or another which he could not foresee, the figures that might be compiled if they were available for the earlier period.

The Court: I will overrule the objection.

Mr. Willson: Q. Would you like me to rephrase the question, Professor?

A. Yes, please do.

Q. There is testimony in Exhibit 2 of the Stipulation re Testimony of William Lee.

The Court: So that it is clear, this is subject to the same considerations I made regarding Dr. Green's testimony, and any finding on your objections on that. The objection is that it goes to the weight, basically.

Mr. Willson: Q. That Mr. Lee and other officers of CCA believed that if these comparisons could be made for all the corrugated plants for the years 1963 to 1965, the differences in productivity and hourly labor costs and unit labor costs would be, at least, as great, and probably greater than those shown for 1974.

Based on your experience, would you also anticipate that if the data were available and were calculated in the same way that it was calculated in these schedules that you have reviewed, that the differences in productivity for the years '63 to '65 would be as great as for the year 1974?

A. Yes, I would expect them to be exactly as you have described them, and let me say why.

It is because the key differences here have to do with differences in payroll.

Wages have been rising in the United States, and even rising in most foreign countries, as well.

But in Cali, Colombia, as a developing country, I think it would be my strong inclination to believe that wages have been rising there at least as fast, and that is what "developing" means, catching up.

They have been rising at least as fast in Colombia as they have in the United States over the last ten or fifteen years.

So with respect to this key payroll variable which drives the unit labor cost, derives a difference abroad versus the United States, I would be inclined to think that these differences which lead to higher profitability abroad than in the domestic market would have obtained, as well, ten or fifteen years ago as they did in these numbers in 1974.

And this is based not on any special knowledge I have of this company in those prior years, as I take it those data are not available, but rather looking at a lot of businesses in the United States and abroad over a period that we are talking about here.

It is a sensible finding, in my judgment.

Q. Cynics sometimes suggest that figures can be made to show anything, and that there are a lot of assumptions, some of which may be arbitrary, that go in calculations, including calculations like these.

After your analysis of these figures, do you regard them as being conservative in showing a higher rate of return in Cali, Colombia, than in California?

A. I have looked through these numbers, and I take them to be conservatively stated, based on the data I have before me here.

And I would cite one example which strikes me as relatively conservative. And that is the allocation of more than twice as much of overhead to the foreign operation as to the domestic operation per MSF of output.

What these basically relate to is taking overhead, which relates to the operation of those foreign businesses, overhead that may be incurred here in the United States, and allocating that out as well on top of Cali's own overhead.

This tends to reduce the profitability from what it would otherwise have been if they had been allocated the same amount of overhead. It is still higher there than here.

I mention that as one example of relatively conservative order of magnitude in the two to one relationship in the allocation of fixed corporate charges.

Q. Is it fair to say that you spent a large amount of your professional life in determining ways to measure the amount of income earned by a particular corporation?

A. Yes, that is true.

Q. Are you familiar with the way businessmen would measure the particular income that would be earned by a particular unit of the business?

A. Yes.

Q. Have you seen a variety of methods by which the calculations would be made, for example, the calculations of how much income a company earns in a particular country?

A. Yes, I have.

Q. I would like to give to you a hypothetical way of making that calculation.

Assume that you had a business operating in California, and one operating in Indonesia, and that the way the calculation was made was to—let me start again.

These are in the same line of business, but you do not find a significant flow of products back and forth. And the calculation is made this way:

You take the total income of the operations in California and the operations in Indonesia, and that is your total net income figure;

You apportion that income to California on the basis of the three-factor formula, the factors of property, payroll and sales, and they are all equally weighted factors;

And the way you make the calculation is that you put into the numerator of the fraction the payroll in California, and the denominator of the fraction, the payroll in California and Indonesia.

You do the same thing with the property, and the same thing with payroll—with sales, and you average those three fractions together.

You then get the percentage attributable under this theory to the state of California;

You then multiply that percentage figure by the total income earned both in California and Indonesia.

Do you understand the formula I have just described?

A. Yes.

Q. Is this among the formulas that you have ever seen businessmen use in attempting to determine income from their operations in a particular foreign country?

A. No, I have not.

Q. Can you imagine or envision a circumstance where businessmen would use this formula?

A. No, not in the real world of business.

Q. Why not?

A. I think there are several reasons.

The first reason is that in my experience, businessmen would not use a surrogate or a proxy method of calculating the bottom line profit when it is possible to go directly to it by more traditional methods. That is to say this hypothetical system that you described to me just might give you an answer which is consistent with the businessman's calculation of profitability, but it certainly might not.

It would be only incidentally the same item, I would think.

And secondly, with any kind of a surrogate or proxy measure like the one you described, the key thing, in my experience, would be the relationship between the surrogate and the thing you are trying to measure.

The key thing here is what is the relationship between sales and profit, and what is the relationship between their payroll and profit? What is the relationship between property and profit?

It is only when all of these factors in the surrogate measure are proportional to the profit as the businessmen would have calculated on the bottom line that this surrogate measure will give you the same result.

It is a rather roundabout way of doing it as you described it. This would be my experience.

Q. Would you expect the true income picture as you would see it, as businessmen would see it, as economists would see it, would be distorted through this formula applied through the international arena?

A. Yes, I would think in this example of California and Indonesia, I would think it would be distorted.

Q. Could you give us an example that would demonstrate why?

A. Let me take a simple example of a company that only has two divisions, one in California and one in Indonesia.

Let's assume these divisions are the same size, to make it simple. And let's say that the property that each of these companies has after initially building these plants is identical, to hold that factor constant.

The two divisions produce a product. They sell it during that year, and the volume of output is the same from the two plants, and the price they sell it for is the same, to make this a simple example.

Sales in Indonesia are ten, and sales in California are ten.

So what I will do now is think of a simple example of a profit and loss statement, with just the essential factors in that profit and loss statement, starting with sales, which is the top line of an income statement on the top row, 10E.

Let's assume the payroll for a minute, total labor cost in California is four per year, and in Indonesia is two per year. The labor cost is half as much.

And the next line on the expense cost picture is an item in which you lump together all the other costs of the operation.

And let me assume that the company uses accountants and economists, and people of old-fashioned business common sense together to try to decide how to apportion all the common costs between the two operations.

The company has one president, one board of directors, and you have to by some way find how to allocate the cost part to operation and part to the other.

Let's assume for the minute economic and accounting and other factors have been brought to bear, and they have used the best common sense, and it turns out to be four for California and four for Indonesia.

Going down the profit and loss statement, what it looks like is Indonesia sales ten, labor two, all other costs four, and the net profit on the bottom line would be equal to four.

In California, it is sales ten, labor costs four, all other cost and expenses four.

So the bottom line profit would be equal to two.

So the sum of this little example is that the total profit of the company would be four plus two, or six, as we calculated it on the bottom line.

Now as I take it from the hypothetical example in this formula that you have just given me, if you applied this formula to apportion the total profit of six, the result would be just backwards, that is, you would take the labor costs, which is twice as high in California as it is in Indonesia, and you apportion twice as much profit to California. That is you apportion four to profit in California and two to Indonesia.

The reverse is true, the reason it is higher profit in Indonesia in the first place is because of the lower labor cost in this example, where sales and property are held constant.

And the effect of the allocation based on labor is to get the profit allocations backwards.

So the total of six was four abroad and two in California.

And the apportion formula would give the opposite. Four in California and two abroad.

Why does this make a difference? Because the businessman is trying to get the profitability right so that he can figure out where to invest his next dollar.

And by the apportionment formula, it looks like California is the profitable operation, where common sense tells you the foreign operation is the profitable operation, and that is the place to put the next dollar of invested capital.

The profitability appears to be twice as much by business common sense abroad than it would have been by this surrogate measure.

So the sum of this is that the surrogate would not work very well at all, vis-a-vis the reality of this very simple example.

Q. If you took this formula and applied it to your hypothetical where you were using just payroll as the apportionment formula and you found—would you expect that a businessman—the use of a formula would indicate that the profit was doubled in California than it was in Indonesia? You would expect a businessman would find himself convinced by that, and the question to him would be that he was going to put in a plant somewhere, and the question is Indonesia or California, and do you expect it would go to California?

A. No, I cannot imagine him making that mistake, regardless of the result of the outcome.

You would look to the fundamental economics of the reality of the situation, and I doubt strongly that he would be fooled into believing the California plant, because of the hypothetical formula that you have given me, was twice as profitable when, in fact, the reverse was true.

I suspect the businessmen that I know would tend to regard the Indonesia plant in this example as more profitable, and if the risks were such that twice as much profit was enough, you would tend to regard that as a better prospect for future business investments.

Mr. Willson: That is all the questions I have.

The Court: All right. I take it, Mr. Plant, you will have cross-examination?

Mr. Plant: Yes, your Honor.

The Court: And do you suggest we do that at 9:30 tomorrow morning?

Mr. Plant: Fine, your Honor.

The Court: Is that convenient to counsel and the witness?

Mr. Willson: It is a question whether it is convenient to our witness, your Honor. We prefer to do it now, obviously, unless Mr. Plant anticipates it will take some time.

The Witness: I would have to cancel my appointment tomorrow at Stanford.

The Court: My attaches have been going since 9:00, as you appreciate.

I don't mind missing a judge's meeting that I am supposed to attend at 4:30, that is fine, but I wonder how much Mr. Plant, if you have more than twenty minutes, which I anticipate you may?

Mr. Plant: Your Honor, what I want, most of all, was to have about ten minutes with Dr. Cerf to review and formulate a few questions on cross-examination. And that I believe will be the biggest cause of delay.

I was going to ask for a continuance if we go on.

The Court: Well I will try to accommodate the witness as much as I can.

And this is the only witness, except for perhaps the Franchise Tax Board—

Mr. Plant: We do not have a witness.

The Court: So with that in mind, I will be happy to accommodate the doctor insofar as I can, but if I see extensive cross-examination, I will have to put it over.

Mr. Willson: I am sure we can work it out to be here at 9:30.

The Court: What I am saying, if that is the only way, I will be glad to accommodate you.

I say if it is more convenient to have him here tomorrow afternoon, he can be here tomorrow afternoon. I don't know your schedule. And if you want to discuss it with counsel, you may.

All I can say, I have to do it tomorrow, because I will be unavailable next week. That is my only restriction.

Mr. Willson: If you could recess, Mr. Plant, do you think it will take a while?

(Whereupon, all counsel confer.)

Mr. Willson: We can make it at 9:30.

The Court: I appreciate that. It does not look like you will be occupied too much beyond that. I will make sure we accommodate you.

Thank you very much gentlemen, and you have the opportunity to prepare, and it might shorten things. See you at 9:30.

[Certificate Omitted in Printing]

FRIDAY, FEBRUARY 24, 1978 9:40 O'CLOCK A.M.

PROCEEDINGS

The Court: The case of Container Corporation of America versus Franchise Tax Board, No. 673492.

When we recessed yesterday evening, Professor McDonald was on the stand.

Dr. McDonald, will you resume the stand.

JOHN G. McDONALD,

called as a witness on behalf of the plaintiff, having been previously duly sworn, resumed the stand and testified further as follows:

The Court: Good morning, Doctor.

The Witness: Good morning.

The Court: We have Miss Tedeschi with us this morning, so, perhaps, it might be well if you state your names for the record.

Mr. Willson: Prentiss Willson.

Mr. Latcham: Franklin Latcham. We're for the plaintiff.

Mr. Plant: Philip Plant for defendant.

The Court: Fine.

Mr. Plant, I believe it's your opportunity for cross-examination.

Mr. Plant: Thank you, your Honor.

CROSS-EXAMINATION

By Mr. Plant:

Q. Dr. McDonald, yesterday you testified as to different factors that were considered by companies in determining hurdle rate. One distinction that you mentioned was the difference between whether a company is going to put on the market a new product as opposed to what you characterized to be a line extension.

Could you explain why a company would make a distinction in this regard?

A. For a given company, a new product to that company is usually regarded as having more risk than an extension of an existing product line, because of their past experience.

That is to say, a new product involves new learning, it involves production, marketing the whole stream of business which is involved with the process following the investment itself. The lack of experience to that particular company simply carries with it an element of risk broadly defined; whereas, an extension of an existing business implies substantial previous experience, and so, the perceived risk to the company in something that they know how to do is regarded as being less.

Q. Well, then, would it be fair to say that the hurdle rates may be dependent upon other risk factors independent of the situs of the proposed investment in a foreign country?

That is to say, you've enumerated certain risk factors associated with business know-how, production and marketing of a product. This type of risk factor, I imagine, would be a relevant consideration whether you're considering an investment in a foreign country or an investment domestically?

A. Yes. That's correct. The site of the investment is one factor, and as I testified yesterday, for an existing business in an existing product line and a given company, the hurdle rate would be higher in a foreign country than it would be in the United States.

Certainly, the product itself and the kind of business area that they're investing in would be another factor, and that would obtain in domestic investments as well.

Q. Are there any risk factors you can think of other than the two we've touched upon; that is, the risk factor associated with the situs of the proposed investment in a foreign country or domestically being one consideration, the other being the consideration of whether or not the company is undertaking a new product line as opposed to expanding an existing line.

Is there any other risk factor which might affect a company's propensity to invest, that you can think of?

A. I think that many individual companies talk about it in a wide variety of language, and if you talk to ten companies, they will break it down in what appears to be ten different ways.

But on a little bit deeper examination, it seems to me it is the environment or the country location and the nature of the product itself from the company's point of view which is central. Often this is articulated in terms of the technology of the product, in terms of the channels of distribution of the product, language which sounds like marketing and production and so on, which may sound a little broader than simply line extension and new product.

And so, I take these to be the central categories, but there may be a matrix in this spectrum which is much more complicated in some countries than just line extension versus new product, and foreign versus domestic.

I meant really to raise that as an example of a four-part classification in one company that I mentioned yesterday.

Q. How complicated in your experience do these hurdle rates generally get? Does a company, for example, focus on a given country and then consider adjusting a hurdle rate, or do they have across-the-board hurdle rates that they apply to geographical areas?

You mentioned, for example, a situation where they had four hurdle rates: domestic, variable, existing product line versus new product line, which in their interplay generated four different hurdle rates.

Does a company get into a more detailed consideration of the matter when they approach the process of seriously considering an investment in a given foreign country, or an investment in a new product line?

A. Here, again, it depends on the company and the industry. The process that I have observed in my own experience is really an evolutionary one. There are many companies that have divided the world into domestic and foreign, and having looked at it a little more closely and then moved away from that simple two-part classification in terms of geography to something more refined, perhaps, first of all, to break it down in terms of industrial European countries versus developing countries, then, perhaps, to break it down further within Latin America.

For example, to say that Peru appears to be risker today, for example, than Brazil might be, because of the relative size of the countries, and so on.

So, I think, perhaps, the best example I could give you of a very refined breakdown would be that used by many large commercial banks do business in many, many countries, and look at each one in terms of its current country risk, as they call it.

Q. Thank you.

Would you say there are situations in which a corporation might disregard its hurdle rate for special reasons? Maybe it would be helpful in conjunction with this question if I enumerated a few hypothetical possibilities.

Suppose there's an increased demand in a country where there's an increased demand for an existing line of products in a country where this company is already established and operating. It might consider the possibility of increasing the line of that product at less than hurdle rate for fear that were it to do otherwise it would permit the establishment of a competitor.

Suppose that a company is approached with an offer of a joint venture by another company whereby the risks attendant to such investment would be spread.

Suppose the size of a potential market in a foreign country is so great that it seems exceedingly attractive on that ground alone.

Suppose a country has surplus raw materials in one of its operations in a neighboring foreign country, and this would provide a convenient source should it commence operations next door.

And consider if you would the concept that a company might gain some prestige from being a quote, "multinational," unquote.

With factors such as this, do you think there are situations where a corporation might disregard its hurdle rate in a particular investment?

A. I think if you talk to corporate financial managers and ask them if they've ever made investments whose indicated returns were less than the hurdle rate, nearly all of them would say yes, and they would start with the corporate cafeteria, and they would start with smokestack investments required by law to clean up emissions into the air, and they would give examples like that of investments which would appear at first glance on the forms that are filled out in which ready return is calculated to have indicated expected rates of return which are less than hurdle rate.

In talking further with them, I think it's important to get beyond the language that they're using, which often says it's a necessity, or it's needed, or it makes good sense, or it has strategic importance, or it's for practical importance.

And I don't mean to address every one of the examples that you've raised, but rather to generally address the point that I think that it's very often difficult to quantify all of the benefits from an investment in concrete terms that go on that form in which rate of return is calculated.

And so, the indicative rate of return from time to time may appear to be lower on an expected basis than the hurdle rate, and costs will go ahead. But the fact of the matter is, I think, that in going a little bit deeper, the real expected rate of return implicit in the decision to go ahead is very often, in fact, greater than the hurdle rate which is indicated.

Let me give you a single example that I looked at recently of a company that went ahead with an investment that had an indicated rate of return of five percent when their hurdle rate was 15 percent.

But when you looked at the forms, you saw that they were just projecting cash flows over a two-year period into the future, a very short time horizon, when, in fact, they really expected to operate that investment for ten or 20 years.

So, the calculation ignored the future cash flows in the sense that if you had taken those into account by making those very difficult expectational projections into the future, the rate of return on the form for a 20-year time horizon evaluation might well have been in excess of the hurdle rate

So, the question there is, was the investment meeting the hurdle rate, or wasn't it?

And in terms of the strict first draft of the forms, it appeared not to. But in terms of a more complete analysis and a longer time horizon the company happened to be using on that form, it appeared that it did.

So, the point of this little example is simply that management's common sense in this case was very much in accord with the thrust of the analysis which says you make investments if they are indicating an expecting rate of return that is in excess of the hurdle rate.

Q. But hypothetically speaking, wouldn't it be good business judgment in a situation whereby, establishing a business operation in a neighboring country, you create a market for raw products of an existing company you have next door, to make the investment in that foreign country at less than the hurdle rate with the expectancy that you are going to increase the return in the adjacent country in your existing business, for example?

A. Well, I'm not sure that I follow your hypothetical example. I might give you one in my own experience, and perhaps, you could tell me if this is to the point that you're raising.

When a large company in the mining business in South Africa decides to go into the mining business in Zambia to the north, they, in the past, evaluated that as a stand-alone investment.

It may have increased their presence in the continent, and there may have been some overhead personnel that would look after both divisions at a very high level, but they made an attempt to allocate the Board of Directors' time, the President's time, to both of these divisions in such a way that the companies truly reflected what an economist and an accountant and good common sense businessman would have thought was a reasonable allocation.

It's done every day. And given those numbers, the rate of return is calculated on the prospective proposed Zambian operation as a stand-alone investment. That is to say, I think it would not have been improved if the investment looked undesirable, simply on vaguer grounds that it might have helped the existing investment in South Africa.

The pencil is sharpened, I think, on investments like this, and each one has to bear its own weight.

Q. But, again, let me try another hypothetical.

You have a country. You have an existing business operation in Country A, and you're considering the possibility of establishing an operation in adjacent Country B.

You have awareness that their competitor's considering establishing an operation in the adjacent country, and you fear that should the competitors get a foothold, it might ultimately end up affecting your existing sales of that line of products in Country A.

Would not that be a factor that you would consider in deciding at what level you would set your hurdle rate?

A. To be sure that I understand, are you suggesting that the Country B new operation would be shipping products physically across the frontier into Country A?

Q. Yes.

A. I think in that case companies that I—for example, let's take Country A being the United States, and Country B to be Canada, where there is substantial shipping in that instance across the border from Canada to the United States.

There would be an attempt in evaluating the proposed investment in Canada to take into account all of the benefits and costs which are associated with that investment.

The benefits and costs are defined normally in business terms as the cash flow to the company with that investment, as opposed to the cash flow to the company without that investment.

So, the incremental benefits and costs of the corporation or in a proposed Canadian investment, all things considered, would be allocated as best they possibly could to that proposed investment, and there would be an attempt made to calculate a rate of return on the incremental investment.

Q. So, is that the same as saying that if you are convinced that the establishment of the Canadian operation will increase the cash flow of the existing United States operation, you would attribute that increase in the cash flow to the United States operation to the Canadian operation in computing their rate of return?

A. I'm trying to be responsive to this notion of shipping a physical product across the frontier, so that I take it what you're saying, it would replace in some sense the production of the American plant, because normally, my experience is companies try to evaluate each investment as much as possible on a stand-alone basis, but there's some attempt made to allocate those overhead costs, and so on, which are common to the whole company.

And I use just as a simple example the President of the company and those people who have to look over all divisions combined, but the first inclination is to try to see whether this thing makes sense standing on its own.

And I have not found in my experience in the real world of business that people make an enormous effort to try to calculate the impact on all other parts of the business of a given investment in a new country.

Normally, it's regarded as much as possible as a separate entity, as a stand-alone new division in the country of Canada.

Q. But you do say "as much as possible," meaning that you do consider the inner relationship of the new operation with the overall business?

A. If it were so dramatic as you described as to replace production in Country A, for example, then you'd have to look at the increment cost of business, the new way of operation as opposed to the old way of operating.

Q. You mentioned previously, I think, the short-run and certain investments made that might not bear an acceptable return for a transitory period of time, but the long-range expectancy would be that they would.

What, generally, are the time constraints associated with this hurdle rate concept? What length of investments do you usually consider, and how long do you usually consider acceptable before a company, say that was starting a new endeavor in a foreign country and a new product line, how long would you allow before the profit made by that operation would reach the acceptable minimum hurdle rate, generally?

I realize it's a tough question.

A. Yes. It's very difficult to generalize very different kinds of business. I understand your question to be that given an indicated investment has an overall rate of return which is in excess of the hurdle rate, how long would it have to be before the year-to-year results come up to that long-term level.

If you take an example, just to be concrete, of an American bank opening up a new branch in Sao Paulo, Brazil, for example, it may be several years before that particular branch is profitable on a year-to-year basis, but the expectation is that as you look at ten years or 20 years, the overall rate of return on that investment will exceed the bank's hurdle rate for doing business in Brazil.

Now, the patience level of the company, in looking at the time horizon for the year-to-year returns to come up to a positive cash flow, just varies enormously from business to business, and it's very difficult to generalize.

There are some companies that are willing to wait five or six years; some will be wait longer. But, generally, these time horizons are rather shorter than that.

That is to say, it may take a year or two to get it up and running, and then it's expected that the operation will stand on its own and be profitable.

But I don't mean to imply that that time pattern will be the same for a Coca-Cola operation in Mexico as it would be for a bank branch in Brazil, or a copper mine in Peru. I think it just varies greatly across different kinds of business.

Q. A couple of questions on the rates of return that you referred to yesterday.

You indicated there are various items that are included in the numerator or denominator of the profit capital investment aspects of the rate of return, that they do differ from one company to another.

What type of variable are there? How can you change capital investment, for example?

A. Let me just give you a few examples.

The two most common varieties of calculation of profit in the numerator simply is pre-tax versus after-tax profit.

And, I would say, in my experience, comparably, the two widest varieties of ways to calculate the denominator, that is, the investment base, would be long-term investment capital usually taken to be total equity investment, plus long-term debt, on the one hand, and assets, on the other hand.

That is to say, the total assets or the net assets in the plant.

Now, most companies make a big effort to use whatever variety of this ratio they come up with consistently throughout the divisions of the company, and they try to define a hurdle rate which is consistent with that definition.

But there are just very many variations on the theme in terms of exact accounting definition of each of those items in the ratio which is profitability.

Q. Isn't it true that the actual profit figure, be it before or after taxes, that a corporation will come up with is dependent upon the particular sets of accounting procedures that it pursues in such areas, for example, as choice of depreciation methods, depreciation lives, inventory methods, allocation of joint costs, methods of accounting for transfers to and from related companies?

A. Yes, it does.

Q. While as you said most companies doubtless use the same sets of accounting procedures and the same general rate of return formula, would it not, without detailed analysis, be difficult to compare one company's rate of return against another company's rate of return?

A. It is important in making comparisons to make the measures on the two sides of the comparison as comparable as is practically possible.

Q. What influence, if any, would a change in the exchange rate of a foreign country currency as opposed to American currency have in the rate of return of, say, a manufacturing plant which an American company has established in this foreign country? Wouldn't that change the rate of return?

A. Are you talking about the expected rate of return, or the actual rate of return?

Q. The actual rate.

A. Now, on a year-to-year basis, focusing on a short run, if our profits in a foreign subsidiary are transferred quarter by quarter or year by year into dollars, then, the short-run fluctuations in the exchange rate do affect the actual rate of return in dollars.

If you take a look at somewhat longer run, for example, the total discounted cash flow rate of return, which might be 20 years in terms of a foreign corporation, then, the short-run fluctuations in the exchange rate are much less important.

Q. Is that based on the assumption that these exchange rate fluctuations tend to level out?

For example, what if a foreign country had a continually decreasing exchange rate of the long-term?

A. No. It does not depend on that. The averaging out is a sufficient condition.

For example, in the case of France, where it seems to fluctuate back and forth, the French franc, vis-a-vis the dollar; but it's by no means a necessary condition.

For example, comparing the Brazilian cruzeiro against the American dollar, that exchange rate has changed in one direction rather than fluctuating back and forth.

The Court: I think the court reporter would like the spelling of cruzeiro.

The Witness: C-r-u-z-i-e-r-o.

Mr. Latham: -z-e-i-r-o.

The Witness: -e-i-r-o.

The reason is—it may appear puzzling at first, but the reason is that the change in the exchange rate affects the real flows in the country. That is to say, changes in the exchange rate, as for example between Brazil and the United States, would seem mostly or always to be in the same direction, reflect the long-range phenomenon that the internal rate of inflation is now and has been higher in Brazil than it is in the United States.

And, so long as that relationship, higher inflation in Brazil than in the United States, continues, then, there will be an erosion in the value of the Brazil currency vis-a-vis the American dollar.

However, that doesn't imply that there is necessarily an erosion in the rate of return that is earned in Brazil, because this higher rate of inflation in Brazil is reflected in local interest rates, and it's reflected in local nominal rates of return that people earn in that country's currency.

For example, while a rate of inflation of 40 percent a year sounds simply astonishing because it is so high, the fact remains that there are interest rates in that country which are 25 or 35 percent in some cases, and people make nominal rates of return.

And by nominal, I mean denominated in the local currency of 40 or 50 or 60 percent. So, while there is an erosion in the exchange ratio in the value of the local currency, vis-a-vis the dollar, I need not imply that over the period of 20 years, the long-term investment, that the rate of return in dollars is necessarily affected.

Now, the rate of inflation reflects the risk, as well as the return side of the equation. But the point I'm making here is simply that both cases, such as France, where there's a vibrating exchange ratio around some mean value, and in cases such as Brazil where there is generally a one-sided continuing change in the exchange ratio—in both of these cases, the expected rates of return on foreign operations of American companies may be realized.

Q. I have trouble, but suppose you have a country and their exchange rate is continually increasing so that if you were to convert their yearly profits into dollars, for the parent company to state a rate of return in an annual report, you would always find that the dollars, because of the increased exchange rate, would be more.

How can this change?

A. May I take a specific example in illustration of the point you're making?

Q. Surely.

A. Let's take Germany, for example. The German mark has been appreciating against the dollar as you've described in your hypothetical just a moment ago

Now, if you take a short-run point of view, the company is in that business to make a very short-run profit, that is, from year to year, and then get out.

And I might add, that's not commonly the case for companies that make the kinds of investments we've been discussing. But if you take a short-run, year-to-year point of view and translate those foreign incomes into dollars, and assume—and this might not be a realistic assumption—but assume that they could be repatriated to the parent country on a year-to-year basis, then this appreciation in that German mark would increase the return from that country.

But, as you go out a little bit longer, the point is that that change in the exchange rate tends to affect the real economic situation from Germany vis-a-vis the United States. That is, it makes the somewhat cheaper dollar as opposed to the German mark, will help American products being exported, and will tend to hurt over time German products as the price of the Mercedes gets higher and higher, compared to a comparable American car.

And the real impact on the economy, as you trace through a number of future years, tends to be adverse.

That is, the purpose of exchange rate fluctuations over time in international business and economics is to level out these differences, that to affect the balance of trade and the rate of return that companies make in that.

So, in the short run, it would be highly favorable to an American-owned operation in Germany, but as the investment took hold, it would tend to be adverse. This is a process of equilibration in the international market.

So, the point of this is it would be incorrect with the long-run point of view to assume that this change in the value of the mark vis-a-vis the dollar necessarily meant enormous long-term windfall gain, or conversely, in a case of a country whose currency was weakening like Brazil, that the [illegible]-run return is necessarily less.

Q. When you speak of this adjustment, you mean the adjustment in import-export of goods between two countries in question? Is that what you mean?

A. Not only between the two countries in question, but from each of those countries to all the other countries in the world.

Q. What you're saying is when it reaches a point where you're not selling Mercedes, that there's going to be an adjustment in the world market which will cause the exchange rate to ultimately change back to become less inflationary?

A. It's not quite so simple or straightforward as that, but what I'm saying, in business terms, it will be more and more difficult to sell Mercedes in export markets, and that what we take to be the international macro adjustment process on imports and exports will have a very real business impact on those individual companies.

And what was taken to be very good news in the short-run may be taken to be bad news in terms of sales and profits as the adjustment takes place.

Q. Now, this adjustment in the world market is—you speak of short-run and long-run, but it would seem to me that the adjustment you speak of might take a great many years.

A. Well, just how long the long-run is varies from situation to situation and country to country. But in an environment where exchange rates are able to change this adjustment process that I call the long-run may be beyond one or two years; maybe three, four, five years, or ten years in working itself out.

It's by no means over the generations. That is, these things, economics does work itself out, in the long run, is by no means out of businessmen's planning horizon.

But on the other hand, I don't mean to imply that these adjustments take place within a few quarters. It's a gradual process. It takes time.

Q. You mentioned yesterday there's a considerable variety of hurdle rates between different companies that you had experience with. I appreciate your earlier testimony that these are considered to be private information, but I do believe that you mentioned that you were of the impression that there's a fairly substantial variety of hurdle rates.

How do you explain the variety? How do you explain, in general terms, certain companies may have different hurdle rates?

A. In my experience, the overriding explanation has to do with the business risk that the company's basic line of enterprise entails; a food company versus a steel company, or an automobile company versus a copper company.

It depends on the business and industry, above all, in which the company finds itself, and depending on the nuance of the calculation, it may also depend on the financial risk of the company; that is, the capital structure of the company within that industry, and capital structures do vary within a specific industry, like the chemical industry, for example.

Those are the two major categories of difference.

Q. To take the concept of risk factor in a foreign country and to convert that into a mathematical expression of a greater expected return seems to me attempting to take something subjective and extrapolate it into a very objective quantity.

Could the fact that the risk factor is a subjective concept attribute—explain any differences?

A. I think not. I think that the central idea here is that all of the relevant risks in a new investment proposal, for example, exist in the present and in the future.

So, by definition, some people would call those subjective in the sense that nobody knows exactly what the future holds. That's the essence of risk itself.

But the fact remains that people do it every day. This is part of everyday business. And people within a single industry, while they may vary from person to person and company to company, do come to form a consensus about the risk, and I take that to be some degree of objectivity when informed and experienced individuals in a single industry agree to some extent. There does come to be formed a consensus about just how risky Peru is, and that is translated not by an equation or mathematical principle, but rather, by everyday business judgment into a number which has to do with the hurdle rate, that is, the minimum required rate of return.

And as the situation changes in a country like Peru, maybe revised upward from [illegible] to [illegible] percent, and that's based on, once again, the informed, economic, political, common-sense business judgment of the individuals who are responsible for those companies.

Q. You indicate there's a common recognition of acceptable hurdle rates, and yet, you testified that the companies regard their own individual hurdle rates as private stock.

How do you explain that?

A. I think it's explained by the reality of the fact that there are, as I talked to companies in a given industry, for example, similarities in the expected rate of return, the minimum hurdle rate required for new investment in the petro-chemical business, for example.

They are in the same ball park, but that need not imply that people in that industry that talk to each other and share that information—it may appear to an outsider that being in the same ball park that it wouldn't make any difference. But still, it is taken to be proprietary private information by the people in that company.

They want to reserve the right to adjust it upward and downward without explaining to the public about that. It is not a deep, dark secret, but it's regarded as being a part of corporate policy.

So, I think it's absolutely consistent to have some uniformity within a spectrum for a given line of business in a given industry, and at the same time, have companies feel that this aspect of corporate policy, as so many others, is their private business.

Q. I think we're not offering cross purposes here. What I'm trying to get and acknowledge is that it is difficult to take the subjective subject of a risk and quantify it into an exact percentage that companies operating individually to determine hurdle rates when looking at the question of whether an accepted hurdle rate in a given country is 18 or 19 percent have a kind of conceptual problem, and the fact that they're in the same ball park with another company, by independent evaluation, they've come up within a percentage or two, nevertheless, there is that fact that there probably is a slight variation in the percentages just due to the subjective character of the evaluation of risk.

A. I think the essential point here with which I would agree is that companies looking at investments independently in Peru would agree that the hurdle rate there is higher than it is in the United States.

But as to the exact figure, whether it's 31 or 32 in Peru and 15 or 16 in California, there may obviously be differences in percentage points in their numbers, but the relationship between the two in that spectrum of hurdle rates is consistent within the industry.

Q. Thank you.

The testimony you gave yesterday regarding your opinion that riskier investments would bring higher actual rates of return, you referred to a study of sales of stock, I believe, in the United States, or sales of equities.

Do you have the author or the title or the cite for that article? I don't think you mentioned it.

A. Yes. The study was done by Professor William F. Sharpe, S-h-a-r-p-e, and it was published in the Financial Analyst Journal several years ago. I don't remember the exact date.

Q. Several years ago?

A. Yes.

Q. About '72, '73, '74, something of that sort? I'm just trying to get a general—

A. Yes. I think it may have been around 1975.

Q. Now, in speaking in terms of the fact that a riskier investment would, in your opinion, generate a higher actual rate of return, you are speaking in terms of averages?

A. Yes. The actual rate of return is an average. I did say that.

Q. By that, you mean that there is no assurance that any company who undertakes a riskier investment might *in any individual instance secure a greater return?*

A. No. If it were true that it were assured to be a higher return, then, it would be hard to attribute greater risk to it.

Q. It's also, I think you noted, true that while generally a given rate of return would on the average be higher under your theory of things, that in a given year it would be subject to fluctuation.

That is to say, that an investment which is a risky investment and which ultimately would generate a higher rate of return, it's hard to say in any given year what it's going to generate by way of return.

I think you mentioned, to use a classic symptom of a risky foreign investment, that it doesn't fluctuate, even though on the average, as you pointed out, in your opinion, it does generate a higher rate of return.

A. I think we saw an example of the year-to-year fluctuations in Schedule 7 that we talked about yesterday, in which the annual rates of return in most of the foreign operations fluctuated more, had more year-to-year variation than did the domestic return.

Mr. Plant: Your Honor, I have no further questions of Dr. McDonald.

The Court: Thank you very much.

Mr. Willson?

Mr. Willson: No. I have no questions, your Honor.

Mr. Latcham: No questions, your Honor.

The Court: You may step down. Thank you very much, Dr. McDonald. I think you're free to leave. Check with your attorneys.

Mr. Willson: Your Honor, I think we have two points we want to agree on before this is over, and we've talked about them.

One of them, one of the exhibits to the stipulation of facts, is the annual reports which are not in there for the truth of the matter submitted, but just simply there.

And there's an item, namely, the financial information attached to the annual reports which Mr. Plant has asked us if we would stipulate to the truth of that information. We'd like to get back and talk to the company.

So, we would like to reserve that question and leave it open, and at some point we'll come in, probably with a written addendum to the stipulation which reflects our agreement on this.

The Court: Perhaps you can file it when you file the briefs, whether or not it's stipulated to.

The first set of briefs, that is, relating to objections—

Mr. Willson: It will just take a couple days.

Mr. Plant: We would reserve the right in the event the plaintiffs felt they could not stipulate to this being admitted for the truth of the matter stated, to then, in effect, make a motion that it be accepted for the truth of the matter stated as a party's admission.

But we're not making the motion now, with the understanding that they may be willing to just stipulate without that, if that's agreeable.

The Court: That's fine.

Mr. Willson: And the second point is on the briefing schedule itself, for the briefs, we agreed yesterday 10, 10 and 5, and then, 60, 60 and 30.

And the question thence, from when does the 60 begin to run? Mr. Plant and I are in agreement we'd like to have that period begin when we have your decision on the admissibility of the stipulation re testimony, if that's acceptable to you.

The Court: All right. The time on the 10, 10 and 5 will begin to run today upon the submission of the matter, and then, it will be ordered that from the date of the—whether it be an order or proposed order of the Court—in other words, I'm not sure what your briefs will show.

So, if it's extremely intricate, I may enter a proposed order and direct a party to enter the final order on the issue.

But from the time of the issuance of that, then the time would run on the other. That's when you'll have notice of my intended order, and you can begin then to prepare.

Now, the order will be then the submission on the merits will be on a schedule of 60, 60, 30—60 days for brief, plaintiff; 60 days response by Franchise Tax Board; 30 days rebuttal—will run the day of the order or proposed order of the Court re stipulation re testimony.

Mr. Plant: Thank you, your Honor.

The Court: Any other matters?

Mr. Plant: I have none.

Mr. Willson: No.

The Court: As I understand it, that which was introduced yesterday jointly Exhibit 1-A, which is a copy, and I can scribble in the margin and so on?

Mr. Willson: As a matter of fact, I think it might be helpful if I give you, also, a copy of the stipulation re testimony, and you could scribble in that as well.

Mr. Plant: No objection to that.

Mr. Willson: 2-A, or whatever. I'll leave you one.

The Court: Thank you.

Then, the issue is submitted?

Mr. Plant: Yes, your Honor.

The Court: Subject to all these contingencies.

Mr. Willson: Thank you, your Honor.

The Court: Submitted, Mr. Willson?

Mr. Willson: Yes. Submitted.

(Whereupon, the proceedings were concluded.)

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